NOTE

This Microfiche meets the quality requirements of the American National Standard for Microfiche of Documents (ANSI PH5.Ø-1975). However, because of imperfections in the document from which it was made, it contains images that are illegible or difficult to read. The source document for this microfiche is the best copy that could be obtained prior to filming.

CIS

S. HRG. 101-352

SECTION 89—NONDISCRIMINATION RULES

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

FIRST SESSION

MAY 9, 1989

Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE

20-998 ==

WASHINGTON : 1989

For sale by the Superintendent of Documents, Congressional Sales Office
U.S. Government Printing Office, Washington, DC 20402

S361-3

COMMITTEE ON FINANCE

LLOYD BENTSEN, Texas, *Chairman*

SPARK M. MATSUNAGA, Hawaii	BOB PACKWOOD, Oregon
DANIEL PATRICK MOYNIHAN, New York	BOB DOLE, Kansas
MAX BAUCUS, Montana	WILLIAM V. ROTH, Jr., Delaware
DAVID L. BOREN, Oklahoma	JOHN C. DANFORTH, Missouri
BILL BRADLEY, New Jersey	JOHN H. CHAFEE, Rhode Island
GEORGE J. MITCHELL, Maine	JOHN HEINZ, Pennsylvania
DAVID PRYOR, Arkansas	DAVID DURENBERGER, Minnesota
DONALD W. RIEGLE, Jr., Michigan	WILLIAM L. ARMSTRONG, Colorado
JOHN D. ROCKEFELLER IV, West Virginia	STEVE SYMMS, Idaho
TOM DASCHLE, South Dakota	

VANDA B. MCMURTRY, *Staff Director and Chief Counsel*
ED MIHALESKI, *Minority Chief of Staff*

CONTENTS

OPENING STATEMENTS

	Page
Bentsen, Hon. Lloyd, a U.S. Senator from Texas, chairman, Senate Finance Committee	1
Packwood, Hon, Bob, a U.S. Senator from Oregon	2
Symms, Hon. Steve, a U.S. Senator from Idaho	3
Pryor, Hon. David, a U.S. Senator from Arkansas	4
Boren, Hon. David L., a U.S. Senator from Oklahoma	5
Durenberger, Hon. David, a U.S. Senator from Minnesota	15
Chafee, Hon. John H., a U.S. Senator from Rhode Island	17
Baucus, Hon. Max, a U.S. Senator from Montana	19
Heinz, Hon. John, a U.S. Senator from Pennsylvania	20

COMMITTEE PRESS RELEASE

Senator Bentsen Announces Hearing on Section 89—Nondiscrimination Rules	1

ADMINISTRATION WITNESS

Trier, Dana, Tax Legislative Counsel, U.S. Department of the Treasury	9

CONGRESSIONAL WITNESSES

Domenici, Hon. Pete V., a U.S. Senator from New Mexico	6
LaFalce, Hon. John J., a U.S. Representative from New York	21

PUBLIC WITNESSES

Burckley, William J., city councilman, testifying on behalf of the National League of Cities and the Government Finance Officers Association, Greensboro, NC	25
Williams, Anthony C., director, department of retirement, safety and insurance, National Rural Electric Cooperative Association, Washington, DC	26
Kelley, Mary, president, Kelley & Co., testifying on behalf of the National Federation of Independent Business, Denver, CO	28
Carswell, Bruce, senior vice president, human resources and administration, GTE Corp., testifying on behalf of the ERISA Industry Committee and the Section 89 Coalition, Stamford, CT, accompanied by Grant Withers, director, benefits, GTE	29
Skadden, Donald H., vice president, American Institute of Certified Public Accountants, Washington, DC, accompanied by Deborah Walker, Section 89 task force chairman, AICPA	36
Hansen, Karl, E., CLU, chairman, task force on health, Federal Law and Legislation Committee, the National Association of Life Underwriters, Washington, DC	37
Richardson, William W., manager, employee benefits, Valero Energy Corp., testifying on behalf of Employers Council on Flexible Compensation and the Cafeteria Plan Coalition, San Antonio, TX	39
Danilson, Ron, associate director, group underwriting, the Principal Financial Group, Des Moines, IA	40

Page

Lagos, James H., past president and member, board of directors, National Small Business United, Springfield, OH 43
Alexander, Donald C., partner, Cadwalader, Wickersham & Taft, testifying on behalf of the U.S. Chamber of Commerce, Washington, DC 45
Child, Kathi, manager of benefits development, J.C. Penney Co., Inc., testifying on behalf of the Retail Tax Committee of Common Interest, Dallas, TX .. 46
Peery, Joseph K., vice president, human resources, Quanex Corp., Houston, TX 47
Galef, Sandy, legislator, Westchester County Board of Legislators, vice chair, National Association of Counties' Labor and Employee Benefits Steering Committee, testifying on behalf of the National Association of Counties, Westchester County, NY 48

APPENDIX

Alphabetical Listing and Material Submitted

Alexander, Donald C.:
Testimony 45
Prepared statement 55
Baucus, Hon. Max:
Opening statement 19
Bentsen, Hon. Lloyd:
Opening statement 1
"Description of Certain Bills and Discussion of Issues Relating to Section 89 Nondiscrimination Rules Applicable to Certain Employee Benefit Plans," committee print from the Joint Committee on Taxation 60
Boren, Hon. David L.:
Opening statement 5
Burckley, William J.:
Testimony 25
Prepared statement 94
Carswell, Bruce:
Testimony 29
Prepared statement 96
Chafee, Hon. John H.:
Opening statement 17
Prepared statement 101
Child, Kathi:
Testimony 46
Prepared statement 102
Coats, Hon. Dan:
Prepared statement 108
Danilson, Ron:
Testimony 40
Prepared statement 109
Domenici, Hon. Pete V.:
Testimony 6
Prepared statement 111
Durenberger, Hon. David:
Opening statement 15
Prepared statement 113
Galef, Sandy:
Testimony 48
Prepared statement 114
Hansen, Karl E.:
Testimony 37
Prepared statement with enclosure 116
Heinz, Hon. John:
Opening statement 20
Prepared statement 121

	Page
Kelley, Mary:	
Testimony	28
Prepared statement	122
Submitted statement of the National Federation of Independent Business, before the House Ways and Means Committee, May 2, 1989	124
Responses to questions submitted by Senator Pryor	130
LaFalce, Hon. John J.:	
Testimony	21
Prepared statement with enclosure	132
Lagos, James H.:	
Testimony	43
Prepared statement	136
Levin, Hon. Carl:	
Prepared statement	139
Packwood, Hon. Bob:	
Opening statement	2
Peery, Joseph K.:	
Testimony	47
Prepared statement	140
Richardson, William W.:	
Testimony	39
Prepared statement	144
Skadden, Donald H.:	
Testimony	36
Prepared statement joint with Deborah Walker	148
Symms, Hon. Steve:	
Opening statement	3
Prepared statement	152
Prepared statement of Blake Hall, Idaho Association of Counties	153
Letter to Senator Bentsen from W.F. "Bill" Whittom, Mayor, city of Rupert, Rupert, ID, dated May 2, 1989	154
Trier, Dana:	
Testimony	9
Prepared statement	160
Williams, Anthony C.:	
Testimony	26
Prepared statement with attachment	155

COMMUNICATIONS

American Bankers Association	166
American Bus Association	168
American Farm Bureau Federation	170
American Federation of Labor and Congress of Industrial Organizations	170
Associated Builders and Contractors	172
Associated General Contractors of America	176
Best Rental Store, Inc.	182
Blue Cross and Blue Shield Association	182
Castle & Cooke, Inc.	185
City of New York	188
Coalition of State and Local Employee Pension and Benefits Issues	190
County of Los Angeles	191
Crane, Hon, Philip M.,	193
Edison Electric Institute	195
Entrepreneurs of America	196
Foster & Gallagher, Inc.	197
Friedman & Fuller	197
Harris, E.W.	198
Hershey Foods Corp.	198
International Union, United Automobile, Aerospace & Agricultural Implement Workers of America	200
Lamske Investments, letter to Senator Domenici, dated March 29, 1989	204
Los Angeles County Bar Association	205
Massachusetts Mutual Life Insurance Co.	212

	Page
Motion Picture Association of America, Inc.	214
Motor Vehicle Manufacturers Association of the United States, Inc.	220
National Association of Colleges and University Business Officers	222
National Association for Home Care	225
National Association of Rehabilitation Facilities	225
National Association of State Auditors, Comptrollers, and Treasurers	228
National Constructors Association	229
National Convenience Stores, Inc.	231
National Coordinating Committee for Multiemployers Plans	233
New York State Department of Civil Service	239
Potomac Electric Power Co.	241
Serco, Inc., letter to Senator Domenici, dated January 31, 1989	243
Sheet Metal and Air Conditioning Contractors' National Association, Inc.	244
Simpson Investment Corp.	247
Small Business Council of America	250
Small Business Legislative Council	253
Society of Professional Benefit Administrators	259
Southwestern Bell Corp.	269
State and Local Government Benefits Association	271
Union Oil Co. of California	273
U.S. Small Business Administration	277
Washington Business Group on Health	285
Wisconsin Department of Employe Trust Fund	286

SECTION 89—NONDISCRIMINATION RULES

TUESDAY, MAY 9, 1989

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 9:30 a.m. in room SD–215, Dirksen Senate Office Building, Hon. Lloyd Bentsen (chairman of the committee) presiding.

Also present: Senators Baucus, Boren, Bradley, Pryor, Rockefeller, Daschle, Packwood, Chafee, Heinz, Durenberger, and Symms.

[The press release announcing the hearing follows:]

[Press Release H–16, April 10, 1989]

SENATOR BENTSEN ANNOUNCES HEARING ON SECTION 89—NONDISCRIMINATION RULES

WASHINGTON, DC—Senator Lloyd Bentsen (D., Texas), Chairman, announced today that the Finance Committee will hold a hearing on the nondiscrimination rules applicable to employer-provided fringe benefits, referred to as Section 89.

The hearing will be held on *May 9, 1989 at 10 a.m.* in Room SD–215 of the Dirksen Senate Office Building.

"The Section 89 nondiscrimination rules originated in President Reagan's tax reform proposals in 1985. While the goals of the provision are laudable, it has become apparent that the rules are causing American business untold headaches," Bentsen said.

"These rules are just another example of the overly complex nature of our tax system. The administrative burdens imposed by the Section 89 provisions must be reexamined, and balanced against the policy of distributing tax benefits equitably and the impact on the budget deficit," Bentsen said.

Bentsen said the Finance Committee will hear testimony on specific problems which employers are having with the Section 89 rules and on suggestions for simplifying the rules.

OPENING STATEMENT OF HON. LLOYD BENTSEN, A U.S. SENATOR FROM TEXAS, CHAIRMAN, SENATE FINANCE COMMITTEE

The CHAIRMAN. This hearing will come to order.

I think almost everyone in this room, and particularly small business, knows something has to be done about Section 89. Major surgery is needed, and it is needed quickly. I will be introducing legislation to make the rules work.

If you consider the original objectives of Section 89, they were admirable objectives. President Reagan proposed them as part of his tax reform initiative, and the idea was that everyone employed in a company would have tax benefits that were comparable. A lot of people even hoped that it would result in an additional extension of health benefits and life insurance benefits to employees. But Section 89 is far too complex. The rules are so complex, they make

"War and Peace" look like a comic book. Even the so-called "experts" can't understand the details.

I was talking to some people last night who were telling me, they are spread across the country—they might have two or three employees in one State, two or three in another, and several thousand in another, and participating in different HMOs—even with a big company, where they have all of the staff of lawyers and accountants to make it work, that they have incredible problems in trying to prove that they have not discriminated. It has even caused some small employers to talk about shutting down their plans and doing away with health insurance.

So, we are not here with any idea of trying to determine whether or not the rules should be fixed, we all agree on that; we are here to see how we can fix them.

The first step is to simplify the rules, to reduce the administrative costs that are put on American business today. Then, we ought to try to achieve the original goals of Section 89. Health benefits should be extended, in an equitable manner. To the extent it can be available to all employers, it should be.

But there is another point we have to consider, and that is the effect on the Federal budget. This committee, with the Budget Resolution, has been charged with meting out $5.3 billion in additional tax revenues. And as we change the rules on Section 89, we will probably lose some Federal revenue. Our job is to find that revenue to replace it. We will have to do that. If we lose that revenue, then we have significant work to be done.

My counterpart on the House side has introduced a bill that has considerable merit to it on Section 89. My colleague here, Senator Pryor, has introduced legislation to assist in that regard, and I commend them all for their efforts. I am looking forward to working together to try to see what we can glean in the best of each of these to bring about responsible legislation on it.

We have got a long list of witnesses today, so I am going to ask that my colleagues keep their opening statements to 3 minutes, if they will, and then we will get on with it.

Senator Packwood?

OPENING STATEMENT OF HON. BOB PACKWOOD, A U.S. SENATOR FROM OREGON

Senator PACKWOOD. Thank you, Mr. Chairman.

I remember when we adopted Section 89 and, very honestly, there was not much controversy at the time. People have no particular objection to the goal. I find very few people who are willing to say the law should allow very highly compensated employees to get superior health insurance plans and should allow lower-earning employees modest or no health plans. No one in good conscience will defend that position.

When we passed Section 89 there was not much opposition to the goal of equality and fairness in health insurance. At the time, no one really knew exactly how the rules would read. I think it is fair to say that those groups who now want changes can not be held at fault for not suggesting at that time what the changes should be in a program that was not then in effect.

In retrospect, we have discovered a number of things:

One, if you are an employer of 10 or less, probably just on the averages you could fail to meet the Section 89 test, and it is nobody's fault. It is not the employer's fault, not the employee's fault, probably not even the regulation's fault; it is just the averages. This problem wouldn't happen if you had 100 employees or 1000 employees, but it can happen if you have 10. So something must be done to make sure that honest employers who want to have a decent health plan for their employees don't fail and subject everyone to penalties, through no fault of their own.

Second, I have very severe reservations as to what may happen to cafeteria plans, something that this committee and this Congress has worked on extensively to try to extend. Cafeteria plans make sense for two-earner families. Cafeteria plans should be allowed to expand, so that the husband might choose health insurance and the spouse might choose child care, if their company has such a plan, without both of them having to have child care and both of them having to have health insurance when they are covered by each other's plans. Cafeteria plans could be jeopardized by Section 89, and no one intended that.

So, as we start the hearing today, I hope we start in good faith. That good faith is: We want to end discrimination. To help, the advice we need is how.

Thank you, Mr. Chairman.

The CHAIRMAN. Surely.

The order of arrival: Senators Symms, Pryor, Packwood, and Boren.

Senator Symms?

OPENING STATEMENT OF HON. STEVE SYMMS, A U.S. SENATOR FROM IDAHO

Senator SYMMS. Thank you very much, Mr. Chairman, and my colleagues.

Mr. Chairman, I am very pleased that you have called this hearing today. I think this is very important. I think the vote that we had in the Senate a couple of weeks ago, 98 to nothing on my amendment and the Senator from Mississippi's, clearly demonstrates that there is support across the country to do something to correct this problem.

I think, also, I agree in part with what my colleague from Oregon said, that there is no intent here to perpetuate unfair and inequitable plans; but I do think the risk on the other side is greater. I heard from so many of my constituents last week, when I was in Idaho, who approached me and said that they are concerned that their small companies are going to have to cancel their health plans, and that they might be uninsurable or have difficulty obtaining that insurance if they have someone with a medical problem in the family. So, I think we have to look at that side to this issue.

I want to ask unanimous consent, Mr. Chairman, to put my entire statement in the record.

The CHAIRMAN. Without objection, that will be done.

[The prepared statement of Senator Symms appears in the appendix.]

Senator SYMMS. I do think this has to be corrected. I think that the tax accountant, Tom Veal, from Touche Ross said it best when he said that, if they had had Section 89 back at the time of the Revolution, it wouldn't have taken 7 years to win the Revolutionary War, because people would have been so outraged.

When I look at this handbook that came out just for one section of the Tax Code—look at this handbook. It is just incredible. The people who make a living selling these kinds of services are telling us that they don't want us to repeal it. So, I think we have to do it.

I want to say, in closing, one other thing, Mr. Chairman. I believe we have to take the bull by the horns on this, regardless of the accounting procedures, the bean-counting, and face the reality that it will cost a billion dollars for the private sector to implement Section 89. At the marginal tax rate of 34 percent, that is $340 million in lost revenue to the Treasury if we don't repair it. So, I just don't buy those revenue numbers that say it will cost $300 million to repeal Section 89.

I think that, somehow, we need to take control of this revenue estimating procedure that we use in the committee, and not allow the bean-counters to drive policy. This policy needs to be fixed for the people and the taxpayers in this country. I don't believe there will be a loss of revenue, and I think we need to come to grips with that.

I thank you again, Mr. Chairman, for calling this hearing. I think it is important, and I urge speedy, expeditious movement of legislation to correct this problem.

The CHAIRMAN. Senator, that is fine; but I think, unfortunately, OMB will decide there is a loss of revenue, and then we will have to pay for it. That will be our job around here.

Senator Pryor?

OPENING STATEMENT OF HON. DAVID PRYOR, A U.S. SENATOR FROM ARKANSAS

Senator PRYOR. Mr. Chairman, thank you. I, too, applaud you for calling this hearing this morning on Section 89, because as we know, it is an extremely volatile, emotional, complex issue with which the Finance Committee has to deal.

Mr. Chairman, on March 17 I introduced with Senator Durenberger S. 654. This was not a repeal of Section 89; it was an attempt to open a dialogue with all interested parties about the issues involved. It was also an attempt to seek consultation with people across the country on how to maintain or build a fair health benefit program that would spread throughout a great majority of employees, and be less expensive and certainly more simplified.

Today we have 39 cosponsors, Mr. Chairman, of S. 654. I have never maintained that this was the sole solution. I actually have no pride of authorship, Mr. Chairman, because, to be honest with you, I don't understand all of this 654. [Laughter.]

Senator PRYOR. And if someone asks me to explain my strong positions, I will yield to my staff man, Jeff Trinca, to do so. [Laughter.]

But we established two ground rules, Mr. Chairman and my colleagues, in introducing S. 654. One of those was some form of testing. The other ground rule was to make it simple. I hope we will consider these ground rules throughout this discussion and in whatever legislation we ultimately use to correct Section 89.

The key provision of S. 654 is the simplified health arrangement. We feel that this particular provision, once again, embodies the very basic premise; and that is, when a company, an employer, makes these benefits available to all of its employees across the board, then they should be relieved of the burden, the heavy burden, the massive and awesome burden, of the very complex testing requirements in Section 89.

Once again, some have criticized us for not just throwing away Section 89, holding up our hands, and saying we don't want anything to do with it. But I think S. 654 is something that can continue the dialogue to see if we might not turn a negative into a positive, and that we might not consider a corrective action we think is very critical.

Part-time employees is something else, that now, I don't have time to discuss. I hope, during the course of the morning, that this can be a matter for our discussion.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

Senator Boren?

OPENING STATEMENT OF HON. DAVID L. BOREN, A U.S. SENATOR FROM OKLAHOMA

Senator BOREN. Thank you very much, Mr. Chairman. Again, I want to join the others in thanking you for calling these hearings. I think Senator Pryor has just set forth very well and very effectively many of the major problems with Section 89.

We had hearings a few weeks ago in the Small Business Committee, which I co-chaired, focusing specifically on the problems that small business has with Section 89. The problems are very, very severe.

After hearing that testimony and having looked at a survey that has been conducted by the State Chamber of Commerce in Oklahoma, I am absolutely convinced that we are actually going to lose many, many health care plans for employees all across this country if we don't act. We need to either repeal Section 89 and start over or, at the very least, to have some very significant modifications along the lines that Senator Pryor has suggested in S. 654.

Many, many small business people have simply contacted me to say, "We are so worried about the possible consequences of an innocent mistake being made in our plan that, to play it safe, we are just going to cancel our plan for all of our employees, and give them an added salary to buy their own plan." Under that kind of scenario, the employees, after paying taxes on the additional compensation, always come out behind. Many of them simply never will actually go out and buy the health insurance that is now provided by employers, and I am convinced that we are going to have many, many more people who are not covered by health insurance in this country if we don't act.

The problems have already been spelled out. The atom bomb-type penalty that is levied against innocent employees, for example, is another very unfair part of this plan. Part of the Section 89 provision is now being implemented; that is, if the plan is thrown out because of a mistake by the employer, the employees all of a sudden end up with an additional tax burden.

As Senator Pryor has spelled out, the accounting of part-time employees, the recordkeeping on former employees, and the lack of a truly simple testing alternative for small firms, are all among the elements that must be changed.

I am pleased to hear that Treasury has indicated that they will not act in any way to enforce this section or this provision until October 1, rather than on July 1. I hope that they will stick with that. I have been concerned by some reports that they might be backing up and saying that they still want firms to file their plans, even though they wouldn't have to have the backup data until later. I hope that is not the case. But we have had too much backtracking by government in the past; small businesses need to have a clear statement that they can rely upon. I hope nothing will be done until October 1, so that we will have a chance to act legislatively in this committee and in the rest of the Congress.

Again, Mr. Chairman, I appreciate your very forceful leadership on this matter, your putting on our agenda, and your indication that you are anxious to see that something actually gets accomplished.

The CHAIRMAN. Thank you, Senator.

Senator Rockefeller?

Senator ROCKEFELLER. There is no question, Mr. Chairman, that we have a problem, and I look forward to hearing the witnesses.

The CHAIRMAN. Senator Domenici is our first witness this morning.

We are pleased to have you.

STATEMENT OF HON. PETE V. DOMENICI, A U.S. SENATOR FROM NEW MEXICO

The CHAIRMAN. I assume if you support the modification of Section 89, with the anticipated loss of revenue, in your testimony you are also proposing where we get the money.

Senator DOMENICI. Yes. I was all prepared for that. I assume there will be so many new accountants and consultants making money, they will pay the tax. [Laughter.]

Mr. Chairman, I really don't have the answer to that question; although, I frankly believe that it may be an overstatement. Nonetheless, I think we can, all together, work that out.

I am not going to take a lot of your time, because Mr. Chairman, in your opening remarks you have indicated that you have already come to the conclusion that this section must be fixed. A month ago I wasn't sure that was the attitude, either in the Senate or on this committee.

Let me repeat, Mr. Chairman, I am going to be brief. A month ago I would not have thought that the committee would have arrived at the conclusion that I hear here today. I had talked to a few people in the Senate, and frankly I wasn't sure that we had

collectively arrived at the conclusion that in this case the cure that we offered was worse than the disease.

I just want to tell you about my own experience. I attended a meeting in Albuquerque, NM, a city of 450,000 people, if you take everybody in the metropolitan area, and 350 people showed up. We asked an accountant expert, a lawyer expert, and a pension plan expert to be on a panel, and it was absolutely amazing—we discovered nobody knows how to comply with this section.

I was asked by a Senator some 6 weeks ago, who is influential in seeing whether we change this or not, "Do we really have any evidence that this isn't going to work?" I have a lot of evidence that it isn't going to work. At that meeting I had a number of people—and I have encapsulated their testimony in my remarks—that said the following: "We are going to cancel the plan we have got;" two said, "We were planning to put plans in—we will not put them in." One was generous and said, "I am going to give each worker a $100 pay raise rather than put this plan in. I might even suggest that, in their best interest, they buy insurance; but I have a very serious doubt that they will. So I believe my employees will go without health insurance."

Frankly, it seemed to me, as that meeting progressed, that there were a number of issues that are rather simple:

One, the 17.5 hour work for part-time workers. There was a real sense of hilarity about it. Since there is no record on it, they wondered how we arrived at this number, and they guessed that somebody just opened the bidding at 16, and somebody said 20, and then maybe somebody said 17, and they split the difference and said 17.5, because nobody could understand the relevancy of 17.5. I believe it is now uninsurable by most of the companies that are offering insurance.

Second, it seems that sooner or later you ought to provide some method for somebody in a position of authority to sign a simple affidavit. Perhaps we should just get a dictionary description of "discrimination" and put it in a verification, and either have the insuring company or an officer of the company be able to just sign a statement saying, "We have offered a plan that doesn't discriminate," and attach their signature. And so long as it is offered to all of the employees, it ought to be considered compliance.

Now, I have only one question, and you are better suited to answer this than I. It seems to me that this is what the people are crying out for. We offer a plan: "The word 'discrimination' means 'equal to everyone.' I am going to sign and say I am offering exactly that."

Then I guess the question you might ask is, can you provide some reasonable test—some reasonable test—that they are not offering a gilt-edged type plan, such that only 10 percent can afford it? And I believe that is do-able. I believe you could come up with that, from the insurance people, that they would merely say, "It is not a gilt-edged plan, it is not prohibitively expensive." Then, I think the test should not be if the employees all participate, but, rather, that it is offered to all, and that the affiant can say, "There is no discrimination."

The people are crying out for something as simple as that.

You know, OMB is an issue in budgeting. Just recently I had to go to the floor and defend that they are sometimes right. They are. But in this case I really think they are wacky. They said, in their regulatory assessment, that the average business person could accomplish these rules in 10 hours. Perhaps I am less than average, but I cannot read the 200 pages of regulation and ask questions about what they mean in 10 hours. First of all, there is no one around to give you the answers to any questions you might have about the 200 pages; you have to have so many people answering, and getting so much information, it is literally impossible.

I submit that you should consider repealing the law—I don't like to say that; as my friend Senator Packwood indicated, we don't want discrimination. But essentially, you have got to find some way to make compliance easier. You might want to exempt small business, and define them. Or, you might want to apply the rule I just described a while ago to small business, at least—through a simple affidavit, either by the insurer or the businesses themselves—that indeed it is offered to everyone and is nondiscriminatory. In just the simple dictionary sense of the word, it ought to be considered compliance.

If you don't want that to be permanent, you ought to do it for some period of time, for 2 or 3 years, so that people can learn what all of this means.

I would like to submit five or six letters as evidence that you are going to lose coverage rather than gain it.

We have a great goal here: Get more Americans covered by health insurance, by the business community of the United States.

With anywhere from 30 to 37 million uninsured, although I am not sure we know exactly what that means, clearly we ought to want more coverage and not less. I believe you are going to get less rather than more, unless you do some very dramatic surgery on Section 89 and do it rather quickly.

Thank you very much.

[Senator Domenici's prepared statement appears in the appendix.]

The CHAIRMAN. Thank you, Senator. That will be helpful to us, and we will take the letters from your constituents concerning what is going to happen to their plans if this continues as is.

[The letters appear in the appendix.]

The CHAIRMAN. Are there questions of the Senator?

Senator PACKWOOD. I have just one question, if I might.

The CHAIRMAN. Of course.

Senator PACKWOOD. Pete, I am curious about one statement: "I am convinced that if discrimination exists, it was occurring in large businesses, not small." That was not the evidence we had at the time we did this. Of course, many big businesses are unionized, and the plans are collectively bargained, and there is no discrimination. The big businesses that were not, by and large had company-wide plans, anyway, that didn't distinguish between management and non-management.

Senator DOMENICI. Let me say to my friend, I gave you the statement before I personally edited it, and I struck that. I am not confident of that, having heard what I heard.

Let me also say, Mr. Chairman, there are a lot of consultants around that offer to fix this. We had testimony from one constituent that they were offered the service, $3,000 plus $20 per employee; but they would not certify that, when they were finished, they had had a good plan.

Second, it is good for the computer business. Somebody is offering a new piece of software in Albuquerque. If you buy it, for $4,000, they claim that software solves this riddle. The only thing is, they said, "You must buy it in 3 weeks, or the price is going up, and there is no warranty that using it will mean compliance."

So with all of that around, I think you are on the right track.

The CHAIRMAN. Thank you, Senator.

Are there further comments?

Senator Symms?

Senator SYMMS. I just wanted to ask you one more question. You said you thought that OMB is right on a lot of things, but on this issue that they are wrong. Do you agree, then, that it would actually cost revenue from the Treasury to repeal it, or not?

Senator DOMENICI. No. Senator, you see, they are required, under our rules, that say for small business, "Tell us what new regulations are going to cost," and they have estimated that this isn't going to cost small business very much. They have said, on average, it won't take more than 10 hours to comply. So I was not talking about the tax side; I was saying that they are probably 5- or 10-fold off on that from the average businessman's standpoint.

Senator SYMMS. Well, Chairman Bentsen has a problem here. Whose numbers are we to believe, whether this costs Treasury money or doesn't cost them money, to comply with Section 89?

Senator DOMENICI. Well, let me say to the committee, I haven't had a chance to really look at that with those who analyzed this situation. I, frankly, have a great deal of difficulty, from what I know to this point, attaching any degree of credibility to a number like 250 or 300 OR $350 million in tax loss on this particular provision. I don't know what else to tell you, other than I just can't believe it.

The CHAIRMAN. I might comment, there, that we have asked the Joint Tax Committee to work with Treasury to try to come up with some new numbers, to see how they might agree or disagree with OMB's numbers.

Senator DOMENICI. Yes. Thank you very much.

The CHAIRMAN. Thank you very much.

Senator SYMMS. Thank you, Mr. Chairman.

The CHAIRMAN. Our next witness will be Mr. Dana Trier, who is the tax legislative counsel for the U.S. Department of Treasury.

Mr. Trier, we are pleased to have you, and if you would, please proceed.

STATEMENT OF DANA TRIER, TAX LEGISLATIVE COUNSEL, U.S. DEPARTMENT OF THE TREASURY

Mr. TRIER. Thank you, Mr. Chairman.

Let me brief in my remarks and give you a little bit of an overview of the things we have been considering on Section 89.

First, as with everybody in the room, we are convinced that very major surgery is necessary, to use your term, Mr. Chairman, to Section 89. We are working literally most of our time on exactly what the nature of that surgery ought to be. We look forward to cooperating with the staffs and Senators and Congressmen in that effort, and we view these hearings as really one of the first parts of that effort. But we would emphasize, as I am sure you would emphasize, that time is of the essence. It is very important that we resolve these matters as soon as possible.

In our effort to look at what changes should be made or what the new approach should be under a provision that replaces Section 89, obviously the starting point for us really, as discussed by Senator Pryor earlier, is looking at a test that at its core is premised on the availability of benefits to a wide range of employees. Senator Pryor's bill, as well as Congressman Rostenkowski's bill, really emphasize that type of approach, and that is the type of approach that we are emphasizing in our efforts to construct a reasonable solution to this problem.

There are a variety of issues that are raised by that type of provision. I think I should highlight a few of them for you, to give you a sense of what we are looking at, even though at this point our work is far from complete.

As you know, the basic premises of these provisions is to say that, as long as an employer has offered "affordable" benefits to a wide range—90 percent, under most of these proposals—of employees, that would constitute compliance. Well, this raises a couple of mechanical and technical issues, which we have been meeting on, and meeting with various groups, and obviously listening to all the testimony.

The first is, how do we define "affordable?" The efforts heretofore have used dollar figures for example, in Senator Pryor's and Chairman Rostenkowski's bill. The first step there, of course, is to analyze whether the dollar figures are correct. The more intractable problem that we are looking at is how they should be inflated over time as the cost of health and wages go up.

The second major problem and one that we have discussed with quite a few groups is, assuming for the moment that we do have, at the base of whatever the replacement of Section 89 is, this affordability concept, this design-based concept, what happens to the employer that doesn't meet the test by a certain amount, and doesn't meet it under conditions where it is absolutely clear the employer is in fact providing quite a few health benefits? This is the so-called "cliff" problem. We are analyzing approaches to that problem, including changes in the amount of the penalty if you have a cliff problem, and, in addition, having one alternative test that could be met.

The thing that I continue to say—and it is the most troublesome thing when we start thinking about exceptions here—is that I don't want to get back into the same monstrosity we had before, where we have one set of provisions and 14 pages of exceptions, and a very complicated bill.

The third type of problem that we have been emphasizing quite a bit in discussing this—and it was alluded to by Senator Packwood before—is what should be the treatment of salary reduction contri-

butions, or contributions that are under a cafeteria plan, under which in some way or another there is a trade of extra compensation for benefits?

As we said in our testimony, we remain committed to the notion of salary reduction plans and cafeteria plans. I think one of the major facts that is important, as was alluded to earlier is the era of the two-earner family. Thus, cafeteria plans represent a concept that makes a lot of sense. We do not want to see the revision of Section 89 have the effect of doing away with cafeteria plans.

We find this a difficult issue. We are analyzing a variety of approaches. One of the approaches may actually be consistent with the approach to the cliff problem we discussed before, which is to have some alternative way of complying with Section 89, rather than the simple availability test.

There are a variety of other problems. I won't go through them with you, but one of the central ones that obviously we are spending a lot of time on is the special case of small business. As I said, starting in the Small Business Committee hearing and said last week——

The CHAIRMAN. Mr. Trier, you go right ahead. Don't pay any attention to the time, because I want to hear what the Treasury has to say on this.

Mr. TRIER. I will finish up pretty quickly.

As I said last week, we are looking at all possible ways to alleviate the special situation of small businesses. By the "special situation," I mean really a variety of problems.

The first problem is simply what I would call an economies-of-scale problem, a certain amount of compliance cost for a small business has an especially big effect, proportionally.

The second type of problem which has been alluded to over and over again by groups that we have met with on small businesses is simply that, when you have these numbers and you have bright line tests, but you have one or two employees who don't quite fit the test, for a small business that can have a disproportionate effect; one or two employees can affect the percentages very much.

The third one is that, as a matter of fact, insurance companies treat small businesses differently. They don't have as large a group, they may have to have individually-rated plans—there is a variety of reasons.

We are far from finished on exactly what our overall proposal would be. We are convinced that special treatment of small businesses is necessary. As you undoubtedly know, we did propose, last week, that we give consideration to an alternative test for them, for small businesses that maintained only one health plan, under which, so long as core health coverage was made available and the majority of people actually participated, we wouldn't have any valuation test, number test, whatever, applied to it. But we continue to look at the overall situation of small business in a variety of respects.

The final point I would make—and I don't want to go too far over my time—is that we are in complete agreement with everybody that I have heard speak on the issues, that the penalty, the sanction, for failure to meet the qualification requirements, which

in today's world falls on the innocent, really does have to be changed.

We have seen the excise tax proposal—the excise tax on the employer of Chairman Rostenkowski. As we said last week in our testimony on the House side, we think that a 34-percent excise tax, at least initially, is too onerous. Our analogy here is that, after all, these are paper requirements—notices, things like that—our analogy is to private foundation rules, under which you have an initial smaller excise tax and a time to repair the problem before the bigger excise tax is applicable, and we suggest that that kind of approach be taken.

We look forward to working with you. We understand that everybody who is concerned with this wants to deal with this intractable problem, consistent with the revenue constraints that we have, and we hope that it is a constructive process.

Thank you.

[Mr. Trier's prepared statement appears in the appendix.]

The CHAIRMAN. Mr. Trier, as Chairman of this committee, I really want the input of Treasury. You have been living with this problem. You have not come up with acceptable solutions, and you understand that and accept that. But when you talk about some of the problems of small business, you talk about the problems of getting group insurance, and a lot of insurers won't offer serious group insurance to the very small employer. You are uttering a specific solution there, and then you talk about a variety of other problems for small business, but without specific solutions offered. I really want those, and want them as early as we can get them, because it is imperative that we move on this piece of legislation. I want that kind of input.

One of the other points, of course, is the question of the revenue loss. I guess you have got a bit of a problem here, as does the Joint Tax Committee, because you have to look at the structure of the legislation proposed in trying to determine how much revenue would be lost—by the provisions, as they are drafted. So, the question is, which comes first?

Mr. TRIER. It is the classic chicken-and-egg problem.

The CHAIRMAN. Yes. But on the other side of it, when we do determine the revenue lost, I also want to hear from Treasury: Where do we get the money? And I want your imprint on it. I want your lips to get mobile on that one. [Laughter.]

I really want to know where it is coming from. You know, we are going to walk that plank together. [Laughter.]

Do you read my lips? [Laughter.]

Mr. TRIER. I understood what came out, too.

The CHAIRMAN. All right.

Mr. TRIER. I understand your sentiments, and we really do intend to be very responsible players in this game, all of us.

The CHAIRMAN. All right.

Senator Packwood?

Senator PACKWOOD. No questions, Mr. Chairman.

The CHAIRMAN. Senator Symms?

Senator SYMMS. I just have one question, Mr. Trier. It focuses on the question of the cost and how much it will cost.

First I would like to say I was very pleased that you at Treasury made the decision not to try to have compliance until after the first of October, until Congress could act on this. But in view of the cost to the economy and our overall competitiveness in international trade, and so forth, it has surprised me that Treasury wasn't more in the forefront of this fight, and that we in Congress had to drag you along to the party, so to speak. I am pleased that you are now involved in it.

But what is the cost of this kind of legislation in terms of the overall economy, productivity, tying up people doing non-productive enterprises instead of producing what it is that their companies are all about? How much do you believe it will cost the economy not to correct this problem? Have you focused on that side of the issue?

Mr. TRIER. I think there are two responses. I would not hazard a guess as to exactly what the total cost is. Speaking for myself, I do not think that the cost of compliance should be underestimated. I feel that it is very important to have something that does not divert the energies of people and the resources of people. It is not the kind of thing, as you can imagine, that leads to an easy revenue estimate. I have put enough pressure on our revenue estimators as it is—it is not really a "revenue," but "cost" estimate—and I don't know if we could really come up with firm numbers.

But whatever it is, I think all of us think that the problem is serious enough. Whether it is for the productivity issue, or whether it is a question of the fairness of government, or whether it is the question of just simply a wrong-headed statute, any statute that costs that much to comply can't be worthwhile. I think we are all focusing on making it significantly simpler. I think that is really the important question, going forward, to stop the damage from being done further.

Senator SYMMS. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Pryor?

Senator PRYOR. Mr. Chairman, one of the costs that Senator Symms talks about is the actual cost of trying to comply with Section 89, up until this point.

In fact, I told my friend Senator Symms earlier this morning that I had just received a letter from a company. They had expended $39,000 to comply with Section 89, and if it is repealed, he wants the Government to write him a check. [Laughter.]

Senator Symms said, "Well, that company is goofy for doing a thing like that." I said, "Well, it happens to be from Idaho; here is the letter." He said, "We have got to help them out." [Laughter.]

I just made that up, by the way. I am just joshing him a little bit. [Laughter.]

Mr. TRIER. It sounds true to me.

Senator PRYOR. But we do have a lot of companies out there who have spent a lot of resources and effort.

Mr. Trier, we have two issues right here that I would like to discuss and these are the part-time employee and leased employee.

Right now we have this magic figure that Senator Domenici talked about, 17.5 hours. We don't know really where that came from. It is my understanding—and I wish you would affirm this, or say it is not right—that most insurance companies will not insure

unless there is a minimum, I believe, of 30 hours. Is this the general policy?

Mr. TRIER. I don't think it is fair to say that most will not do it at 30 hours. We have evidence that there are several who will do it at lower than 30 hours.

Whatever is true, I think that 17.5 represents a significantly different situation for them. As you know, the notion is that part-time employees are more likely to be ill, or whatever.

We have heard, by the way, from some insurance companies, that at least at some period of time they could get down to 25, if they are not at that level now.

Senator PRYOR. Well, I think that not only this committee but also the Treasury Department must revisit this issue, as we must revisit the issue of the so-called "leased" employee, contracting out for services by particular companies. More and more this is being done in American business. It is my understanding that under Section 89 these people also have to go through the same tests as the regular employee of the company. Am I correct?

Mr. TRIER. That is right. And as you know, there are proposals to change that treatment, such that you at least wouldn't have to cover leased employees if they were subject to a minimum plan of the type that you or Chairman Rostenkowski have proposed, if their employer, the one who is leasing, covered them under a core health benefit plan.

Senator PRYOR. Well, we have a fine line to walk there in case we don't want to have abuses. We don't want to have companies leasing all of their employees or services. We can understand that. There could be abuses.

Mr. Chairman, my time is up.

Senator BOREN. Thank you, Senator Pryor.

Mr. Trier, on the announcement that was made that we will delay any action on this until the first of October, I wanted to clarify that. Now, that is not simply a matter of not having to gather the data until the first of October, but has the date been put off in terms of filing the plans?

Mr. TRIER. There is no filing requirement.

Senator BOREN. Nothing needs to go forward? There have been some rumors that there might still be filing requirements to go forward. So, everything has been put on hold until the first of October, is that correct?

Mr. TRIER. Right. All July first dates have been moved to October first. In fact, we have put in some other smaller easing of the compliance period. The whole notion, of course, being that we very much need the next couple of months to get the legislation correct.

Senator BOREN. To give us time to act.

Mr. TRIER. Right.

Senator BOREN. And I would assume that your own report and recommendations will be available, fairly shortly, then, in order that we can move forward?

Mr. TRIER. We are working daily on it, I think it is fair to say.

Senator BOREN. Senator Rockefeller, any questions?

Senator ROCKEFELLER. Just one, Mr. Chairman.

Under the Pryor amendment, when you talk about a nondiscrimination safe harbor, it is unclear to me what that would be. When

it said "in lieu of"—the four-part or the two-part test—would this be "in addition to" as well as "in lieu of?" of?

Mr. TRIER. I think it is completely "in lieu of."

Senator ROCKEFELLER. In other words, it would wipe out the four and the two, and it would be a substitute?

Mr. TRIER. I think the way I would state his bill, which is not necessarily the way that some of the other alternatives work, is that it is really a two-track system. And if you do comply with the simplified health benefit portion—there is a term that I am forgetting, but whatever it is called—you are out of all the other complicated four-part test, period, end of story.

On the other hand—and this is under his bill, not Congressman Rostenkowski's—if you were one of those employers with a complicated life, and for whom the simplified version didn't work, under the facts, you could be under the other ones.

Now, as we are addressing that issue, as I said earlier, certainly we think, at the core of the statute, there should be a simplified version. The real question is what the level of alternative compliance should be—whether it should be just one rule, or whether we should have all of Section 89, in its greater glory, as an alternative, or whatever. But at the core we would have the simple version, too, I think. And I think most people seem to be thinking that way.

Senator ROCKEFELLER. Thank you.

Senator BOREN. Senator Durenberger?

OPENING STATEMENT OF HON. DAVID DURENBERGER, A U.S. SENATOR FROM MINNESOTA

Senator DURENBERGER. Thank you, Mr. Chairman.

Mr. Trier, I am going to ask you a question, and probably make a statement leading up to the question, because I think it would be helpful if I knew whether the administration was looking at this as a tax problem or a health insurance equity problem.

I call particularly Bob Packwood's attention to the question I would try to frame, because he has been our leader as long as I have been here in trying to use the employer-employee relationship and tax policy in that relationship as a creative way to buy the things in large numbers that you can't afford to buy otherwise.

I sat over there in 1985 and 1986, when Packwood went out to get a beer and came back with a tax bill. [Laughter.]

And I think I have some recollection of some of the reasons why this non-discrimination got in there. One is because he has been against discrimination for a long time. But, second, because the administration then felt very strongly about the fact that the tax subsidy under the employer-employee health insurance buy was out of whack. In other words, the more you spent, the larger subsidy you got; the bigger company you were, the bigger your subsidy; the more money you made, the bigger your subsidy was.

And while Senator Packwood and I have differences of opinion on the notion of how to reform that, I think the essence of what we are dealing with here is not just one of those complicated tax issues, it is the reality of how in the world we can facilitate the purchase of health insurance in employment without an inequity between some employees and other employees.

So, that is what I need to get you to respond to, because as soon as my election was over last November, the first thing I heard about was Section 89. And because I have got a clever tax guy, I said, "You go to the Dave Pryor clever tax guy, because he sits on that side of the table now, and you work something out." So, these two very clever tax legislative assistants got together and came up with this tax bill, which has a dollar cap in it based on weekly contributions, to try to determine what plans are fair to all employees and which ones are not fair.

We got a bunch of cosponsors. When we finally put the bill in, it looked like a reasonable solution. The chairman of the House Ways and Means Committee looked at our bill and adopted something a little bit bigger with another dollar cap. But I finally got to this issue last Friday. I sat down and looked at the dollar cap, pulled out the Federal Employees Health Benefit Plan and said, "Try to find something in here that would pass muster."

The realities are that health insurance costs so much in America today, because we haven't been able to control the cost, that there is no way to use the tax system fairly under the present system to buy health insurance for low income people. It just can't be done.

Under the Pryor-Durenberger formula, the monthly employee contributions are $29.30 for the single plan, $58.60 for the family plan. Compare that with the 1989 "your share, Federal employee" of the monthly premium for Aetna. Instead of the high-option plan, the one you buy if you have a lot of kids or you expect to be sick, instead of the $29.30-a-month employee contribution, "Your contribution, David, if you buy this for your family, is $168.65." The low option is $66.03. That is compared to our $29.30. If you want to buy the family plan, we say the cap is at $58.60, meaning if the employer lays out $58.70, you have a discriminatory plan. The Aetna plan is not $58.70, the high option plan is $318.70. But that, folks, is not your rich executive's plan. That is not Ma and Pa taking advantage of the little employees in their business by having generous contributions for themselves subsidized. That is Federal employees. The highest one gets paid—what?—$89,000-some a year.

So I think we have a larger problem here than any of us have fully appreciated. Because when Treasury does something we don't understand and makes everybody mad, we attack the symptom, rather than really getting at the heart of the problem.

I am going to make a suggestion for my colleagues, but I think somehow, during the course of this year, we have to make it clear that if an employer sets up a separate plan without any deductibles, co-pays, just for the hifalutin' folks, that will show up on the W-2.

The only way, it seems to me, we solve this other problem is by turning to this new bipartisan commission that we created. Senator Pryor is on it, Senator Baucus is on it, Senator Heinz is on it, and I am on it from this committee. The commission is supposed to come up with an answer to the question: How can we, as public policy in this country, facilitate the purchase of health insurance in the work place for every employed and self-employed American? I am just wondering out loud if that isn't going to be the only way to ultimately solve this problem.

I am sorry I took so long to lay it out, but do you have a reaction to that?

Mr. TRIER. I would like to react at general levels and specific levels.

First of all, as I tell everybody, about my job at Treasury, I think that within the Office of Tax Policy a very large percentage of the time in the future will be spent on health and retiree policy, period; not talking about whether it is Section 89, but talking about it in all its full splendor, whether it be retiree health, whether it be health, period.

As you know, we have been working on a report on health benefits, and I will guarantee you that I am farther into the economics literature and how all of this affects the provision of health services than I had cared to be before I got into the job; but I think you have to have that overall perspective.

One aspect of that question is exactly what role the private voluntary system performs. I read your comments at a committee hearing the other day—I think it was in an exchange with Senator Kennedy. The real question is: Exactly how do you fine tune the system we have got for the provision of health care? And I think, in considering Section 89, we do have a narrower question. As you said, we ought to make it work, itself; but we have to be attuned to what the broader questions are.

Just so it is not left as a misimpression, the key to the Pryor-like approach or Rostenkowski approach is not necessarily to stop people from taking the more expensive plan that you alluded to; the affordability concept is that somewhere, somehow, these can be something the world can afford, at some level, as an option. We may go farther, but we can at least get the core health benefits. And the theory there, of course, is that if you have something that is very expensive, it may be that a few lower-paid end up paying for it; but it won't be a broad group of them. So, affordability is different than saying that we have got a cap.

[The prepared statement of Senator Durenberger appears in the appendix.]

Senator BOREN. Senator Chafee?

OPENING STATEMENT OF HON. JOHN H. CHAFEE, A U.S. SENATOR FROM RHODE ISLAND

Senator CHAFEE. Thank you, Mr. Chairman. Just a couple of quick questions.

Do you think there is a need for this legislation?

Mr. TRIER. I think there is tremendous need for it.

Senator CHAFEE. That is, not for fixing up 89, but to have 89 to start with?

Mr. TRIER. Yes. Whether or not you call it Section 89, this four-part test or whatever, I, myself, am convinced that there is a need at some levels for a non-discrimination ruling in the Code.

Senator CHAFEE. Next, the small business. In here, as I understand it, there is a separate test for small business. Am I correct in that?

Mr. TRIER. "In here" means in my testimony?

Senator CHAFEE. In Section 89.

Mr. TRIER. No.

Senator CHAFEE. The suggestions are that there be one, then?

Mr. TRIER. Right.

Senator CHAFEE. With the limitation being 20 employees. That is certainly what Senator Domenici was talking about. What other suggestions are there?

Mr. TRIER. Well, the other suggestion that I have heard frequently—in fact, we had a tentative suggestion at that level—is 10; but with regulatory authority to go above 10 when there were indications that the reason for the special exception, that it is special insurance treatment, was applicable.

Senator CHAFEE. How high would you go? My point is that I come from a State, like most States, I guess, that has a multitude of small businesses. But if you have got 50 employees, you are certainly no giant, and you don't have a staff of attorneys waiting around for something to do.

So I am sympathetic to their problems. I just believe that thinking in terms of 20 or 10, or whatever it is, is really looking a little low as far as the number for the cutoff. I am sympathetic for those who have got 100, actually.

Mr. TRIER. I am, too.

Senator CHAFEE. That doesn't mean to say they have a big staff that can sit around and interpret this kind of material.

Mr. TRIER. My response to that is, I honestly think we are dealing with three different groups now, roughly speaking. We are talking about real small firms for those who really don't have insurable groups of the normal kind. We are talking about the 100-person firms. I used to represent a lot of people that I thought were small clients, that had 100 or 200 employees, and I think, really, that the availability type of test that Senator Pryor proposed, and that kind of simple availability design based test, is really most appropriate for that type of employer.

And then, frankly, we have talked to employers of 40,000 employees who are perfectly satisfied. You know, they had very complicated cafeteria plans, and 27 different options.

Senator CHAFEE. The yellow light is on here, so let me just say this: It seems to me, in approaching this, I don't think you should try to draw up regulations that are going to cut off everybody at every pass. I think, make them as simple as you can. Of course, that is a wonderful criteria, "make them as simple as you can." [Laughter.]

But realizing that maybe somebody will get through the net, somehow, we will catch up with them. This isn't the last time we are going to deal with this subject. We can catch up with those people, if they really abuse the program. But I think to come up with 200 pages of regulations is just putting too big a load on the horse.

Thank you, Mr. Chairman.

[The prepared statement of Senator Chafee appears in the appendix.]

Senator BOREN. Senator Baucus?

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA

Senator BAUCUS. Thank you, Mr. Chairman.

Mr. Trier, I think you have got the message, and I want to just reaffirm it.

At 8:30 every morning in my office I go through the mail. I have a round table at the center of my office. I have two or three people in my office helping me to answer the mail—stacks right in front of me. I go through each letter, one by one, and I can tell you that there aren't many issues that have generated more mail than Section 89 over the last 4, 5, 6, 8, 10 months. It is just constant, just a barrage.

Also, when I am home, I can't tell you the number of businessmen who walk up to me—and these are good people; thoughtful, honest-to-goodness decent people, who are just beside themselves, are just throwing their hands up. They are irate, they are angry, they are ticked off. "Why can't you repeal the damned thing? Can't you drastically curtail it?"—whatever.

I understand if big government and sometimes agencies, with the best of intentions—in this case, trying to deal with potential discrimination of employee benefit plans—tend to go awry. But I am just here to reaffirm what you already know, and that is that 89 has to go through drastic surgery or be repealed.

Now, I have cosponsored Senator Pryor's bill. I have also cosponsored Senator Domenici's bill. The fact is, we have to work together—Treasury, the Congress—to find the revenue to drastically cut back or curtail; otherwise, we are going to have to delay. I doubt that we will totally repeal 89, but otherwise we will have to delay the implementation of 89 for another year or two, or whatever.

I have seen the rules, the regulations. What I got is a 300-page manual. I saw the manual; it is a gigantic manual. Obviously, businessmen should be spending their time making a better product, marketing their product, not spending their life in trying to understand these complex rules and regulations.

Frankly, I tend to praise the bureaucracy and Federal employees. I think 99 out of 100 are trying to do a good job. They are. They are trying to do a good job, just like all of us in the Congress are trying to do a good job. But the fact is, this has gone too far—89 has gone too far. I think we all have the message here. It is necessary for us to tie the knot, get it wrapped up very quickly; so that when I have my "dirty mail" meeting in my office, I don't get quite so many 89 letters; but, in fact, any 89 letters I get will be, "Gee, thanks for straightening it out; we really appreciate it."

I see Congressman John LaFalce sitting here. I want to commend him. I think he has done a very good job, as have others, in raising the consciousness of members of the House and the Senate to this issue.

Again, I appreciate your being here, and I urge us to completely wrap this up, very quickly.

Thank you.

Senator BOREN. Thank you very much, Senator Baucus.

Senator Heinz, any questions?

OPENING STATEMENT OF HON. JOHN HEINZ, A U.S. SENATOR FROM PENNSYLVANIA

Senator HEINZ. Yes, Mr. Chairman.

First, a comment. Most of us have been privileged to serve on this committee for many years, many Congresses. At the end of every session of Congress over the last 8 or 9 years, there has been pressure to come up with some revenue, but never any taxes; and, of course, we are all against raising taxes. Russell Long used to say, "Don't tax me, don't tax thee, let us tax that fellow behind the tree."

It is my view that the current conventional wisdom about how Section 89 developed, is that the Senate went to conference with the House and got hornswoggled. We went in saying that what we wanted, in terms of non-discrimination, was availability to employees, appropriate and affordable health benefits packages, and that "somehow" we got ambushed into accepting what has been called a "benefits- or results-oriented solution." This conventional wisdom is not wrong, but it is incomplete.

What happened is that the need to raise revenue, tax policy considerations, how to get more money without leaving any fingerprints on the tax rates or any other part of the Tax Code, intersected, as Dave Durenberger was saying, with health policy. And the result was a $350 million estimate as to revenues that would be raised, in conjunction with a health policy judgment that the results—namely benefits conferred on employees—was going to be increased.

Is there anything wrong with that equation? Namely, that we are counting on more money from the business firms that are supplying health benefits to employees, and at the same time we are telling them, "Please provide far more benefits to the average employee."

Mr. TRIER. I think my response would be that it is not necessarily inherently wrong; but, if pressed to its extreme, I think it is obvious to all of us now that you have the result that you in fact decrease coverage or have people not adopting plans. You may say "revenue," but you have pushed our voluntary health insurance provision system so far that, ultimately, your goal to increase coverage is defeated.

Senator HEINZ. It was nice talking with you. [Laughter.]

Mr. TRIER. A lone dialogue.

Senator BOREN. Thank you, Senator Heinz.

[The prepared statement of Senator Heinz appears in the appendix.]

Senator BOREN. Our next witness will be Congressman John LaFalce.

Let me say, Congressman, we are very glad to have you. As Senator Baucus has already made reference, many members of the committee know of your work on this particular issue. Many of us also have had the privilege of serving on the Small Business Committee, and of course we follow your work as chairman of the Committee on Small Business in the House of Representatives. You have certainly made a record of which you can be justifiably proud, being an advocate for small business in this country, and making

the rest of the members of Congress sensitive to the problems—the special problems of those in small business.

We welcome you to the committee, and we look forward to hearing your statement and your suggestions.

STATEMENT OF HON. JOHN J. LaFALCE, A U.S. REPRESENTATIVE FROM NEW YORK

Congressman LAFALCE. Thank you very much, Senator. It is a pleasure and honor for me to be here.

Before I begin, I would like unanimous consent to put the entirety of my text into the record, and I will speak extemporaneously.

Senator BOREN. Without objection, it will be entered.

Congressman LAFALCE. The first thing I would like to do, and I would be remiss if I didn't do this, is to associate myself with the remarks of Senator Heinz, Senator Chafee, and Senator Durenberger, in particular, because I think they express thoughts which so closely parallel mine, and I will try to develop them.

I was not a member of the Ways and Means Committee, and obviously not a member of the Senate Finance Committee, so I am not sure what Congress was intending to do. I am not sure that we intended to do what we wound up with in Section 89. I think Section 89, as I reconstruct the history, was drafted by individuals who were staff assistants in the Department of Treasury at the time when it became imperative to raise some money, to fill some hole, to do all those wonderful things such as increase the personal exemption, the standard deduction, lower the rates, et cetera.

I also suspect that it came about because there were two things that some individuals would have liked to have done that didn't have very good marketing labels.

The first one was, "tax fringe benefits," and nobody liked the idea of taxing fringe benefits. I liked the idea; I thought it was a terrific idea. I loved the Treasury bill that was first proposed in November of 1984. I think that Senator Packwood and Chairman Rostenkowski introduced it at that time, at the behest of the Reagan administration. It had logic behind it: you put a certain lid on the fringe benefits that you can receive free, and you tax everything above and beyond that. Unfortunately, that was a non-starter; there was too much opposition.

Industry opposed it because, because they oppose industrial policy. Although if there is an industrial policy for them—and there surely was an industrial policy in the Tax Code for the insurance industry—"Well, you don't want to change that."

Labor opposed it, because this was a way of walking away from the bargaining table with no more than a cost of living increase in wages, but making out like a bandit on fringe benefits, and still have those fringe benefits non-taxable.

That was a non-starter.

We have a health problem, too. A lot of individuals are talking about government health insurance—non-starter; no money. Other individuals were talking about mandating health benefits—non-starter; unbelievable opposition from the business community to that.

How can we fuse these two concepts, of taxing fringe benefits and some way mandating health benefits? "We need a new marketing tool."

I gave a speech one, in 1981. I called it "The Packaging of Public Policy—Government by Euphemism and Slogan." It proceeded on the assumption that more people have ears to be tickled than understandings to judge. That is true. That is very true.

So, somebody—since I am speaking pejoratively here, I will have to say it was staff from the Treasury Department—came up with this idea, "Well, let us label the Section 'the anti-discriminatory section.' And with this anti-discriminatory section you have to be for it, because if you are against it, by definition, you must be a bad guy; and if you are for it, by definition, you must be a good guy. And it will accomplish two things: (1) it will tax some fringe benefits; and (2) it will have the effect of mandating health benefits. We will be able to accomplish it, but with a different marketing strategy."

Now, that may or may not be correct, but Senator Heinz offered his analysis of history, and I offer mine.

I have couple of problems with that, though. First of all, I think it is safe to say, and the easiest thing for us to say, is that we didn't know what we were doing, and I will say that for all 535 Members, because if anybody knew what we were doing, we wouldn't have enacted Section 89.

And on the assumption of discrimination, who did we assume discriminated? The small businessmen, where most of the employees in the United States who don't have health insurance work? Well, yes, but also the big businesses, who have collective-bargaining agreements that have been entered into—between General Motors and the UAW, between Bethlehem Steel and USX and the steelworkers—and we assumed that they must have been guilty of some type of conspiracy, because we assumed they discriminated.

We assumed that all of the not-for-profit organizations in America discriminated, too; we assumed that the National Association for the Advancement of Colored People discriminated; and we assumed that the American Diabetes Association discriminated, because we applied this across the board.

We also assumed that every level of government, from the smallest local level of government to the State governments to the Federal Government, was guilty of discrimination.

So we felt there must have been this widespread discrimination across the entire United States of America, so rampant, so widespread, so odious that it required the intrusive hand of the Government.

And we did this, I suggest, without an iota or shred of evidence. To my knowledge, there was no testimony regarding discrimination by any of these entities with respect to insurance. I am unaware of the Federal Government's discrimination. I am unaware of General Motors' discrimination, et cetera.

Somebody put it like this: "There must have been a suspect ant hill of discrimination out there, and we decided to drop an atomic bomb over the entirety of the United States of America to get at that suspect ant hill."

For all of those reasons and many, many more, I introduced legislation to repeal Section 89. I am pleased to say that, as of this moment, 302 Members of the House have joined with me in that effort, to repeal Section 89 outright.

Now, there are different approaches that can be taken:

Outright repeal is one.

Replacement of it—de facto repeal, but with something new, immediately, in the same bill is another. That is the approach that Chairman Rostenkowski seems to be taking; and, of course, it is my intent to work with him, especially since he has about 28 members of the Ways and Means Committee as cosponsors of the vehicle he is considering.

I don't know what the Senate Finance Committee will do, and therefore I will give you my best counsel as to what should be done:

First of all, take the subject of discrimination. When I was at Jesuit high school, Canisius High School, I asked, "Why do I have to take 4 years of Latin?" The good Jesuit priest said, "Because we want to develop your faculties of the mind. We want to develop your faculties to discriminate, to be a discriminating man."

We tried our best to be discriminating, and I try to do it every single day, because to discriminate can be noble. It can also be odious. There are odious discriminations. If you discriminate on the basis of sex, if you discriminate on the basis of race, if you discriminate on the basis of ethnic origin, that is odious, and illegal, and unconstitutional.

On the other hand, when I hire individuals, I discriminate in favor of the intelligent and against the unintelligent. I discriminate in favor of the hard-working and against those who are not quite as hard-working.

And what form can discrimination take? Well, we can discriminate with respect to cash. We do that all the time. For those who are more "worthy," for those who are more "needed," we discriminate on the basis of cash. We give them more money. We will give them bonuses.

We also discriminate in certain other ways, too. We might discriminate on the basis of either their ability or their length of service, regarding the vacation that they can take.

An interesting question is: If it is permissible to discriminate on the basis of cash, why should it be impermissible to discriminate using cash equivalents?

Now, I think you can make a good argument that there are certain types of discrimination with cash equivalents that should be prohibited. Query, however, whether the Tax Code ought to be the instrument to prohibit or to discourage that type of discrimination.

That raises the point that Senator Durenberger made: What purposes ought the Tax Code attempt to achieve? It seems to me that the 1986 Tax Code attempted to achieve a purpose of using the Tax Code for the purpose of raising revenues, and removing the Tax Code as a rationale for the decision making that was made by the private sector: "Let the business community of America make decisions based upon business judgments rather than tax consequences."

The CHAIRMAN. If you would, summarize. We have quite a number of witnesses. We appreciate your testimony, and we will enter it in the record in its entirety; but if you would, summarize, please.

Congressman LAFALCE. All right.

I would recommend that this committee consider, in the first instance, simply repealing Section 89. Now, some would say, "Well, what about the revenues that it would lose?" I would argue it would not lose revenues. It is estimated that next year it would raise about $100 million, and the following year about $125 million, or so. I think the $350 million was over a 3-year period of time.

But according to the witnesses who have testified before me, the compliance burden on the employer community of America is going to be a minimum of $1 billion and probably closer to at least $5 billion. It is my judgment that simply by repealing Section 89 we would make money for the Treasury; we would be enhancing the productivity of the business community of America. If we implement Section 89, we would so impair their productivity, their competitiveness, and their profitability so that we would actually lose revenues.

If you are going to do something, if you are going to replace it, I would not recommend replacing it with some discrimination test. I think that is too difficult. I would rather go for the 1984 Tax Bill, which taxed excessive fringe benefits, pure and simple. Now, that would take a little bit of political courage, to be sure. There would be political opposition to it. But that has the basis of logic to it. It would raise revenues, and it would also put a constraint on the use of fringe benefits as a way to circumvent the above-ground economy and the use of cash.

If, in the third instance, however, you decide that it is necessary to have some type of discrimination test—and that is apparently the approach that the Ways and Means Committee has taken; I am hoping you will not find that to be necessary—then I would make it as simple as possible. I would make it based upon plan design, exclusively, and availability.

There has been a lot of talk, too, about who is to be exempt, and there is a tremendous amount of sentiment for exempting the small business community of America. I strongly support that, exempting the small business community of America.

The CHAIRMAN. Thank you, Congressman. You have to summarize it, please, because I have 12 distinguished witnesses waiting.

Congressman LAFALCE. I am sorry. Yes.

But then, where would the discrimination lie that you would be getting after with the rest of the bill?

I thank you very much.

[Congressman LaFalce's prepared statement appears in the appendix.]

The CHAIRMAN. Thank you.

Are there questions?

[No response.]

The CHAIRMAN. Thank you very much, Congressman.

Senator SYMMS. Thank you very much, John, for your testimony and for the work that you have done to bring this issue forward and focus attention on it.

Thank you.

Congressman LAFALCE. Thank you.

The CHAIRMAN. Thank you.

Our next witnesses will be a panel consisting of the Honorable William Burckley, testifying on behalf of the National League of Cities and the Government Finance Officers Association, from Greensboro, NC; Mr. Anthony Williams, the director of the Department of Retirement, Safety and Insurance, National Rural Electric Cooperative Association, from Washington, DC; Ms. Mary Kelley, president of Kelley & Co., testifying on behalf of the National Federation of Independent Business; and Mr. Bruce Carswell, the senior vice president of Human Resources and Administration, the GTE Corp., testifying on behalf of the ERISA Industry Committee and the Section 89 Coalition.

We are very pleased to have you. Mr. Burckley, if you would, proceed. We will take your entire statement and put it in the record; but if you would give us a summary of it, please.

Thank you.

STATEMENT OF WILLIAM J. BURCKLEY, CITY COUNCILMAN, TESTIFYING ON BEHALF OF THE NATIONAL LEAGUE OF CITIES AND THE GOVERNMENT FINANCE OFFICERS ASSOCIATION, GREENSBORO, NC

Mr. BURCKLEY. Mr. Chairman, I have summarized. I know that you are very busy today.

Mr. Chairman, my name is William Burckley. I am a city councilman of the city of Greensboro, NC. I am also a Certified Public Accountant. I am here today on behalf of the 16,000 cities and towns represented by the National League of Cities and the 11,000 State and local finance officials of the Government Finance Officers Association.

We have found that the burdens of Section 89 law and related regulations far outweigh the benefits for public-sector employees. My city has 2,208 current employees, and 100 percent are covered under a city-sponsored employee benefit plan. We estimate it will cost the citizens of Greensboro at least $34,000 to comply with Section 89 in the first year, and a minimum of $12,000 per year every year thereafter.

The city of Greensboro offers the same selection of benefits to all employees, from our city manager down to our lowest-paid hourly worker. Our estimated cost of $34,000, we believe, is conservative and represents the cost of putting one police officer and his equipment on the streets to combat crime and drugs. Our policy force is already 60 members short; we cannot afford to spend $34,000 to get ready to comply with Section 89.

Benefits provided by State and local government employees undergo a process of public review, be it by the State legislature, the local council, or at the bargaining table. Because this scrutiny allows little room for discrimination, exemptions should be extended to the public sector.

Efforts to simplify the existing law would provide considerable relief to State and local governments. We appreciate Senator

Pryor's efforts to change the current Section 89 rules and regulations.

Approximately half of the 87,000 State and local governmental units will benefit from the modification in the definition of "highly compensated" to exclude the requirement that the "highest paid" must be considered highly compensated regardless of salary level. Some of the smallest towns have employees eligible for the earned income tax credit who would qualify as highly compensated for the purposes of Section 89 testing.

We would encourage the chairman and the Secretary of the Treasury to clarify, in a public statement, that entities that meet this revised definition will not have to undertake Section 89 testing. Our concern is that many small governments will hire consultants and expend funds over the next few months, before any legislation is passed, to comply with the law.

We have several areas of special concern for State and local governments. They are: The contribution limits, collective bargaining plans, definition of "employer," excise tax on State and local governments, cafeteria plans, and retiree plans.

The private sector has many more options available to it for complying with Section 89. They can drop the benefits entirely, switch to the employee-paid benefits or gross-up the salaries of the highly paid to compensate them for any additional tax that must be paid on excess benefits. Public employers have fewer options. Benefits are generally viewed as a contractual right of employment in the public sector, and are set by legislative means, making diminishment or elimination nearly impossible. Moreover, budget constraints make the "grossing-up" option fiscally out of reach.

Mr. Chairman, the differences I have discussed strongly suggest that selective treatment under Section 89 be provided for State and local governments. Although we clearly understand the intent of the law—to avoid federally subsidized discriminatory benefits, we remind the committee that State and local government employee benefit contributions are not deductible expenses for public employers but are a direct cost to State and local governments. Therefore, we provide benefits to our employees without Federal incentives, and for good public policy reasons, and through an open public process.

I appreciate the opportunity to testify today. I would be pleased to answer any questions you may have.

Senator PRYOR. Thank you very much, Mr. Burckley.

[Mr. Burckley's prepared statement appears in the appendix.]

Senator PRYOR. Mr. Williams?

STATEMENT OF ANTHONY C. WILLIAMS, DIRECTOR, DEPARTMENT OF RETIREMENT, SAFETY AND INSURANCE, NATIONAL RURAL ELECTRIC COOPERATIVE ASSOCIATION, WASHINGTON, DC

Mr. WILLIAMS. Good morning, Mr. Chairman and members of the committee.

My name is Anthony C. Williams. I am the director of the Retirement, Safety and Insurance Department of the National Rural Electric Cooperative Association. NRECA's thousand rural electric

member systems serve 27 million Americans in 46 States, and the various pension and welfare benefits that NRECA administers covers 125,000 employees and their dependents in those localities.

NRECA continues to participate actively in the ongoing public policy debate over health care coverage. Two research reports commissioned by us last year provided new information on this important issue. Our comments today reflect what we have learned in this extensive survey of small rural businesses, as well as our own experiences with our members.

We support the policy goals of expanding access to health care coverage and ensuring that coverage is non-discriminatory. We believe, however, that Section 89 is an unnecessarily burdensome way to achieve those goals.

Because most rural electric cooperatives are smaller employers, and because rural areas depend on smaller firms for jobs, we are especially concerned about the law's effect on smaller firms.

The law's 80 percent alternative test was intended to be useful for smaller employers, reducing their testing burdens. We have, however, learned that many employers who do not offer discriminatory benefits will nevertheless be unable to use it. In our survey of employee benefits offered by smaller employers, we found that nearly one-quarter of smaller firms in rural areas did not achieve high enough participation rates in their plans to be able to use the 80 percent test. Our preliminary estimates also suggest that about a third of our rural electric cooperative members will not be able to use the test.

Utilization rules, to be fair to the employer, are inherently complicated and were one of the causes of the complexity of Section 89. NRECA believes that employers who make health care benefits to all or a substantial part of their employees on a fair basis should not be penalized for their employee selection. Accordingly, NRECA adds its voice to those advocating that non-discrimination tests be based on eligibility for benefits, rather than coverage of benefits received.

Limits on allowable contributions reflects concern over maintaining the affordability of coverage and avoiding discriminatory benefits. We believe that fixed-dollar limits could discourage employers from adopting plans and from offering dependent coverage and could impose a particular burden on smaller firms.

Small firms depend on part-time workers significantly more than do larger employers. Consequently, the need to cover most part-time employees under the current law seriously concerns us. Employers, particularly smaller firms, cannot be expected to provide coverage to those who do not have a significant attachment to the firm, as demonstrated by more than part-time employment.

Finally, NRECA urges that the Section 89 effective date be delayed until at least January 1, 1990, and an additional year for smaller employers.

That concludes my testimony, Mr. Chairman.

Senator PRYOR. Mr. Williams, thank you. Your full statement will be placed in the record, as will be applied to all of the witnesses this morning.

Ms. Kelley, we appreciate your being here, and we are looking forward to your statement.

[Mr. Williams' prepared statement appears in the appendix.]

STATEMENT OF MARY KELLEY, PRESIDENT, KELLEY & CO., TESTIFYING ON BEHALF OF THE NATIONAL FEDERATION OF INDEPENDENT BUSINESS, DENVER, CO

Ms. KELLEY. Thank you, Mr. Chairman.

I am pleased to be here today as a board member of the National Federation of Independent Business, as an active Democrat, as a woman, as a CPA/bean counter and, most importantly, as a real business owner, to urge your repeal of section 89.

Section 89 is unfair. It is unworkable. It will achieve nothing other than reducing the number of workers covered under health plans.

What is Section 89 trying to accomplish? More coverage? There clearly will be less. No discrimination? Quite frankly, there is no evidence that such discrimination exists. Section 89, indeed, discriminates, itself. It especially goes against those with pre-existing conditions, and other underwriting concerns, such as age or gender.

Taxation? Is that the point of Section 89? As horrible as I think that would be, it is more desirable than Section 89.

Small business clearly wants to comply with the laws of this country. With 89, they have two choices: They can spend money, time, and effort to see whether or not their plan works—or they can even develop a plan that may work, or may not work—or they can simply abolish the health care as a benefit.

This impact, I think, will create an entirely new population of medically indigent.

Section 89 is unfair and discriminatory, in that the sanctions are against all employees, whether or not they have controls over the decisions. There is a great deal of concern that if an employee receives a taxable benefit because they had a medical claim of let us say $5,000. We could see an $18,000 wage earner suddenly having an additional $1,000 tax bill.

It also indicates that 5 percent ownership equals control. Those of us who have been in a partnership know that often 51 percent barely equals control.

Section 89 does not recognize the reality or the difficulty in obtaining health insurance for small companies. My firm has been in existence for 8 years. Over the last 5 years we have had four different health insurance plans—not because I wanted them but because the plans radically changed, coverage was taken away, or we were in small groups that no longer had insurance coverage.

There are simple differences in rates, due to underwriting considerations. It is not unusual to have an employee with a $75-per-month premium, another premium with a $115-a-month premium for exactly the same coverage. If the $115 premium belongs to a highly compensated employee, your plan won't qualify, although the coverage is identical.

In our firm, we have an employee who has a disease, Crone's Disease, who has a very difficult time obtaining insurance. We have an HMO which costs $98 per employee. She cannot be covered by it. With a lot of work and research, we found an insurance company that will cover her for $43 a month—it sounds great; I should

switch everybody. However, the coverage is not as good; she has a personal $5,000 annual exposure. But, because we have even provided her that insurance, does that mean we don't qualify under Section 89?

Section 89 is not fair. It clearly discriminates. It is complex and costly. It may increase tax revenues slightly in the short term. Long-term, I believe it will cost us as a society much more as we see a whole new class of medically indigent and we reduce job creation.

Thank you, Mr. Chairman.

[Ms. Kelley's prepared statement appears in the appendix.]

Senator PRYOR. Ms. Kelley, thank you very, very much.

Mr. Bruce Carswell?

STATEMENT OF BRUCE CARSWELL, SENIOR VICE PRESIDENT, HUMAN RESOURCES AND ADMINISTRATION, GTE CORP., TESTIFYING ON BEHALF OF THE ERISA INDUSTRY COMMITTEE AND THE SECTION 89 COALITION, STAMFORD, CT, ACCOMPANIED BY GRANT WITHERS, DIRECTOR, BENEFITS, GTE

Mr. CARSWELL. Thank you. I am pleased to be here today.

I am Bruce Carswell, Senior Vice President of Human Resources and Administration for GTE, and I am representing ERIC and the Section 89 Coalition.

Those two organizations I believe have been in the forefront in providing some efforts to make Section 89 manageable. We do not think that tax-favored health benefits should be exempt from reasonable non-discrimination rules which are not unduly complex and not counterproductive, as the current Section 89. We appreciate the chairman's thoughts on that, and Senator Pryor in his bill in terms of recognizing that, and we feel somewhat encouraged by the comments we have heard today.

We have long advocated a design-based approach to testing, because we believe this test assures availability of affordable coverage.

H.R. 1864 embraces certain concepts which we do endorse.

First of all, it has provided some relief for all employers, both private and public. We believe that there is a reasoned and simple bill, and all business deserves a simple test, if you will, that it can be equally applicable to all.

Second, we feel that it focuses on the test of availability of coverage, which substantially reduces the data burden that we have been encountering.

On the other hand, there are a number of problems that we ask the committee to take into account in development of legislation.

First, we believe the 90 percent standard is too high, particularly when combined with other provisions which in some cases include leased employees, in some cases exclude them, which is very poorly defined. The exclusion of union employees, in terms of making the calculation, will enable some employers to fall out of compliance and therefore face a precipitous penalty. The elimination of the separate testing rule also makes the 90 percent rule much more difficult. Therefore, with a precipitous penalty, we would advocate an 80 percent rule.

Second, the bill indexes employee premiums to wage inflation. We feel, in order to keep the proper balance agreed upon by employees and companies alike in the allocation of costs, the sharing of costs, if you will, it should be based on a medical cost of providing index, if you will, in providing that allocation.

Third, the bill provides that leased employees don't have to be counted if covered by a leased company. That really doesn't go far enough, because Treasury regulations have not really provided us with a reasonable definition, and employers can't determine who are leased employees. Therefore, it should be revised.

Fourth, the bill requires separate testing of union employees. We feel that the employer should have the option to combine that with the overall test to meet the 90 percent, or 80 percent, if you will.

We are also concerned with the treatment of flexible benefits, which was referenced by a number of people. We have been incentived to provide cafeteria plans and spending accounts, and we feel that this should not be counterproductive to that in terms of a defining test.

Finally, we are concerned that the continuous-testing coverage rule is too arduous and not producing enough result with respect to highly compensated employees, and therefore that test should be done once a year.

Finally, 1864 delays rules for former employees for 1 year, and we feel that is not enough. We should wait for Congress to define what a "former employee" is.

We thank you for the opportunity to contribute our ideas, and we look forward to working with you.

Senator PRYOR. Thank you, Mr. Carswell.

I was not present at the time Mr. Withers was introduced. Does he have a statement?

Mr. CARSWELL. No, Mr. Withers is my associate. He is Director of Benefits for GTE. Thank you.

Senator PRYOR. Thank you very much. So, I assume he agrees with everything you just said. [Laughter.]

Mr. CARSWELL. If he doesn't, he is my former director of benefits. [Laughter.]

Senator PRYOR. Thank you very much.

[Mr. Carswell's prepared statement appears in the appendix.]

Senator PRYOR. Senator Packwood?

Senator PACKWOOD. Mr. Carswell, I just want to make sure I understand your statement. You say, "We do not think that tax-favored benefits should be exempt from non-discrimination rules." So you are totally opposed to repealing Section 89? Or, if it is repealed, do you want some kind of discrimination test?

Mr. CARSWELL. We feel that Section 89 should be repealed, or modified substantially, and it needs such a substantial revision that I suppose "repeal" is not a bad word, if you will.

We feel the concept of discrimination, in terms of a non-discrimination in terms of benefits, is a universally accepted concept; and, if there are simplistic rules which companies can comply with for the benefit of both providing benefits to their employees and meeting overall discrimination rules, we would favor that.

Senator PACKWOOD. I am not quite sure I follow. You say they should not be exempt from non-discrimination rules. You are not

going to have no rules; you say there should be some kind of non-discrimination rules?

Mr. CARSWELL. Yes, there should be. I am sorry.

Senator PACKWOOD. All right.

Now, Ms. Kelley, I don't understand one paragraph of your statement; it is on page 5: "It is our members' belief that voluntary provision of employee health insurance by employers should be held to be in the same category as the President's proposal and Congress place home mortgages, obligations to Social beneficiaries, disabled veterans, and charitable contributions." What does that mean?

Ms. KELLEY. Senator, the thought behind that is that an employee tax-free benefit has been sacrosanct, if you will, in the United States. And indeed, that has been considered base-line compensation, and free from taxation, very similar to the home mortgage interest deduction, which has been considered a very necessary and appropriate Schedule A deduction for the American taxpayer.

Senator PACKWOOD. Let me ask you about the home mortgage deduction. A taxpayer has a million dollar cap on two homes. In essence, that is a discriminatory threshold. Are you suggesting the same thing for employee benefits?

Ms. KELLEY. What I am suggesting, Senator, is that the employee benefit of tax-free health care, especially, remain tax free; that, if there is evidence of discrimination, that indeed that be taken care of; but that we don't see evidence of discrimination, and there are other ways of getting at this issue, should it even exist.

Senator PACKWOOD. Then I want to ask your judgment on this, because when we went through this, we honestly didn't have much help on how we should draw any rules from the groups that would be affected. But over the years, this is what we have discovered. And I indicated it was more likely that small businesses had discriminating plans. The big employees are either unionized, or they have very non-discriminatory broad plans. But discriminatory plans did not normally exist in small business—the insurance company, the barbershop, the stationery store, the pharmacy. It was usually professional corporations that had a disproportionate number of highly-compensated employees, and they had a history of discriminating long before ERISA. They would also discriminate in pension and retirement plans in favor of their highly-compensated employees. We found it in health plans. It is a small strata of small business, but highly compensated. And that evidence has been there over the years.

Should we make an effort to stop it?

Ms. KELLEY. Senator, let me share with you what my experience as a CPA has been over the last 14 years—and, of course, we have never looked at CPA firms as doing this; we have only considered the legal firms the ones who did it—and that is that I have in fact not seen such discrimination.

I have seen, with my clients and with colleagues, that if a small business offers a medical health insurance plan, they offer it to all employees. We have an NFIB member whose statement was in other testimony in the House, who is indeed an insurance agent. She said, with her 100 small businesses, she had never seen a case where there was discrimination.

Clearly there has been opportunity, if you will, to look, for other means of getting compensation, to other individuals, I think, in the professional firms that you indicate, but not in the health insurance area.

Senator PACKWOOD. Thank you, Mr. Chairman.

Senator PRYOR. Thank you, Ms. Kelley.

Senator Durenberger?

Senator DURENBERGER. Thank you, Mr. Chairman.

I wonder if any of you who were here when I asked the question of Mr. Trier would care to comment on the difficulty we are all going to have with dollar caps, or some other way of distinguishing what is a discriminatory health plan and what is not.

I guess I can say, for one, that the notion that we are going to continue the system of any employer can buy for any employee whatever health plan he or she chooses to purchase is not in the cards. I mean, the subsidy is too great today for the large dollar health plan, and that is why this Section 89 is in the bill, and I will do everything I can to oppose outright repeal of the notion of discrimination.

However, having said that, putting something in its place I find extremely difficult. I just wonder if any of you who were here might comment?

Mr. CARSWELL. Well, just a brief comment. It is a difficult problem. Frankly, even the term "discrimination" is difficult. It is discrimination at a point in time, or equity at a point in time, or it is revenue raising at a point in time. Those all get mixed up there.

But we are at a point in time where we have gone through four or five decades of enthusing industry and unions and employees, alike, to make a package of compensation which includes health and includes other benefits, depending on the needs of those people. And I think we have to take great care when we start to make that change, and recognize how it is impacting the companies, the employees, the new companies that are coming behind. It can't just be changed overnight, as if all of that was wrong.

So, I think some judgment, and calculation, and prudence is required as you gentlemen are encouraging at this meeting.

Senator DURENBERGER. Yes. It just occurs to me that we are going to spend an awful lot of time chasing down a dog that ain't going to bite, if we keep trying to implement this Section 89 the way we are trying to implement it.

But the real problem of discrimination, if that is what we are worried about, somebody gets a better deal than the other, the real problem of discrimination is in the current tax law and the tax treatment for health plans. That is the discrimination.

If Chrysler can buy a $500-a-month plan for each of its employees, including all of its retirees, and all of that is deductible to the company and tax-free income to the employees, while self-employed people have to buy their health insurance at 50 percent more, with after-tax dollars, that is the discrimination in this system.

You know, for us to spend a whole lot of time trying to deal with this one, adding all of these extra costs to all of those people out there who want to get rid of their health insurance, anyway, because it is getting to be such a large burden, it seems to me in our

society it is getting to be counter-productive, and we ought to start spending some time getting at the real discrimination.

Mr. BURCKLEY. Senator, let me say this, too: On the State and local level we do not discriminate. We have a plan in my city that we offer to every single employee, from the highest paid down to the lowest paid. You pick and choose what you want. There is no discrimination.

The people who are going to benefit the most, and the only people who benefit from Section 89, in my opinion, are those people who offer no benefits whatsoever; there is zero cost to those people. It is going to cost my community $34,000 the first year, $12,000 every year thereafter. That is a burden. We would like to be able to spend that money on police and fire protection, garbage collection, those types of things. We don't feel we ought to be spending those tax dollars—and we are very, very wise in how we spend our tax dollars—on something that will not benefit the citizens of our community one iota.

The CHAIRMAN. Thank you.

Senator Pryor?

Senator PRYOR. Yes, Mr. Chairman. Thank you.

Ms. Kelley, I have always kind of prided myself for being an ally of the group that you speak for today, the NFIB. It is a very splendid organization. We have a lot of good members across the country and in the State of Arkansas, and I don't want to say that we are totally, 100 percent, apart on this.

Now, I am trying to simplify a member, this Section 89. Your testimony states that your group wants to repeal it, just out and out repeal it.

This relates to Senator Packwood's questions to a degree, and I didn't hear your answer. If you get your wish, and we repeal Section 89 and have nothing on the books, what will be your position on taxation of fringe benefits?

Ms. KELLEY. Senator, first of all let me thank you for your support of small business. You have a very strong record in that area, and it is appreciated.

Senator PRYOR. Thank you.

Ms. KELLEY. If indeed my wish comes true and you repeal Section 89, my thought with regard to the taxation of fringe benefits is that I would like to see it continue to be a tax-free benefit.

If, indeed, we believe that, because of the need to balance the Federal budget—with which I concur; we need to raise revenue in this area—I would suggest that we cap fringe benefits at a certain dollar amount and tax the amount over that.

Senator PRYOR. All right. I am going to ask this: You don't have to answer orally, but I would like to respectfully request that you and the NFIB might make some comments on design-based testing as provided in S. 654. I would truly like to know NFIB's position there and what you think about this.

I would also like to ask the question, is this not the type of approach that would address some of the major concerns that NFIB has with Section 89?

Ms. KELLEY. Senator, I am not familiar with the exact test that you are discussing. But certainly, what we see in current legislation and in modifications of that legislation, it is that tests on

small firms tend to get just really wild because of the small numbers.

If you look at a 90 percent test, for example, on a 15-member firm, you are looking at having to cover 14 people. The realities are that you may have one or two people who can't be covered. So, all of those tests tend to be burdensome. But we will be happy to submit to you some of our concerns in writing.

Senator PRYOR. Fine.

[The information appears in the appendix.]

Senator PRYOR. Mr. Chairman, in the interests of time, and my time is about up, I think I will yield back the balance of my time.

Thank you very much.

Ms. KELLEY. Thank you, Senator.

The CHAIRMAN. Ms. Kelley, I want to commend the NFIB for the work they have done; but, as I understand your recommendation, it is that you are calling for complete repeal of Section 89.

Ms. KELLEY. Yes, sir.

The CHAIRMAN. And to replace it with something more rational. How would you take care of discrimination with what you replace it with?

Ms. KELLEY. Senator, what I would recommend is that, indeed, the issue about discrimination is one with which we all concur; but I think what we had prior to 1986, what we could have again, in terms of a facts-and-substance approach, if you will, in the law, certainly looking at audit history as part of the normal audit of a corporation or a small business, or a large business, that indeed the issue of discrimination be examined at that time and be taken care of. There is still opportunity, in a very simplified way, to look at it wherever it might exist and take care of it. And I think there probably should be a statute that says there should not be discrimination in that area. But it doesn't need to require, as we have seen today, 200 pages of regulations.

The CHAIRMAN. I want you to give me some specific, very simple ways to take care of it, in writing.

Ms. KELLEY. Yes, Senator.

The CHAIRMAN. So we can give it consideration, because we very much want your input.

Ms. KELLEY. Thank you, Senator.

[The information requested follows:]

FUNDAMENTAL SECTION 89 REFORM

Health Plans. A health plan would be considered nondiscriminatory if it is available to either 70 percent of all employees or a classification of employees that does not discriminate in favor of highly compensated employees.

- Pre-Tax Reform law would be the guide for determining what constitutes a "nondiscriminatory classification."
- The term "highly compensated employee (HCE)" would be defined as provided by Tax Reform except that 5% ownership of a business would be dropped from the definition.
- Certain categories of employees could be excluded in testing (see section 89(h); however,
  - —Part-time would be defined as under 30 hours;
  - —Short-service would be defined as under 12 months; and
  - —Exclusions need not apply to all plans of the same type (i.e. Section 89(h)(3) would not apply).

The CHAIRMAN. Councilman Burckley?

Mr. BURCKLEY. Yes, sir.

The CHAIRMAN. When it comes to local government employees, we have historically tried to craft legislation to take care of some of their unique concerns, and we understand that. But I am troubled somewhat by the idea of a total exclusion.

It may be correct that government employees' plans historically have less discrimination, generally. I am not sure that that is totally the case. There might be some counties and some cities that might be quite discriminatory. And for the lowest-paid employee, it would seem to me that when he is discriminated against, whether it is in the private sector or the public sector, it is a matter of concern. It would also seem to me that if we exempted local government from Section 89, the private sector might wonder why we were so tough on them and not on the public sector.

How would you comment on that?

Mr. BURCKLEY. Let me say this. I can just give you my own experience, and that is the experience of my city and the other elected officials within our region.

We are finding, quite frankly, that the discrimination that you are talking about is very few and far between, and it is punishing everyone, because you have a few bad apples. I think that we can simplify what we are asking people to do; there are other methods than what has been proposed in the original Section 89 rules and regulations.

I think we can simplify this, to be quite frank with you. I, for example, represent more city employees in my district than any other city councilman, and I can guarantee you that if there was any discrimination in our plan, then I would certainly hear about it.

Now, as far as saying that the private sector may think that they are being discriminated against because you are letting State and local government units off the hook, well, we already do that in many areas of the Tax Code. So I don't think that is a valid argument. If you look at ERISA, for example, we do not comply with ERISA, so I don't really think that that is a valid reason for imposing these very costly measures upon State and local government.

I really feel that, in my own situation, I would rather spend that $34,000 to put that extra police officer on the street to fight drugs and to fight crimes, or to give better public service. I don't think that we as a city government are involved in the type of discrimination that you are referring to. I know that our government is not. As I said earlier, we offer the same health care package to our city manager as we do to the lowest-paid sanitation worker in our city, and that is true around the country.

The CHAIRMAN. Mr. Williams, the rural electrification group has done an awful lot of work. They haven't just complained; they have done a lot of research on small employers, and that has been very helpful.

But amongst those things you recommend, you are talking about increasing the hours of work for a part-time worker. We heard some comments about how the number that we have in the law at present was arrived at. Does background information you have developed result in a number of hours that you would recommend?

Mr. WILLIAMS. I don't think there is anything in the survey, Senator, that would indicate what a minimum number of hours should be. Certainly, we think what has been proposed is too low.

I think you will find most insurance companies are at the 30-hour-per-week level, or some maybe a little bit less than that. I think we could live with something of that nature.

The CHAIRMAN. Thank you.

Are there further questions?

[No response.]

The CHAIRMAN. If not, thank you very much for your contribution. We appreciate that.

Our next panel consists of Mr. Donald Skadden, who is the vice president of the Section 89 Task Force for the American Institute of Certified Public Accountants; Mr. Karl Hansen, CLU, who is chairman of the Task Force on Health, Federal Law and Legislation Committee, of the National Association of Life Underwriters, from San Francisco, CA; Mr. William Richardson, the manager of Employee Benefits for Valero Energy Corp., testifying on behalf of Employers Council on Flexible Compensation and the Cafeteria Plan Coalition; and Mr. Ron Danilson, who is the associate director, Group Underwriting, The Principal Financial Group, of Des Moines, IA.

We are pleased to have each of you.

[Pause.]

The CHAIRMAN. Mr. Skadden, I would assume you are here to testify against Section 89, and I would think that this would provide a life-time annuity for all accountants, that in effect you may be testifying against your long-term best interests; but let us hear it.

STATEMENT OF DONALD H. SKADDEN, VICE PRESIDENT, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, WASHINGTON, DC, ACCOMPANIED BY DEBORAH WALKER, SECTION 89 TASK FORCE CHAIRMAN, AICPA

Mr. SKADDEN. Thank you, Mr. Chairman. I am pleased to be here to surprise you and testify against Section 89.

My name is Donald H. Skadden. I am vice president of taxation, the American Institute of CPAs. With me today is Deborah Walker, who chairs our tax division task force on Section 89.

We believe that we have reasonable, workable suggestions addressing many issues in this area, including all three of the problems that Mr. Trier identified this morning.

Ms. Walker will summarize our recommendations, after which we will both be pleased to answer questions.

The CHAIRMAN. Ms. Walker?

Ms. WALKER. Thank you.

Mr. Chairman, the AICPA applauds you for holding this hearing to review the rules applicable to employer-provided fringe benefits. In fact, the AICPA is most interested in good tax policy as opposed to an annuity for those of us that are the members.

Because of that, we are most concerned about the compliance cost that Section 89 generates. We believe that the law's significant

complexity results in widespread misunderstanding of the rules, and excessive cost.

We strongly recommend that your committee develop a design-based proposal which focuses on eligibility rather than on coverage. It should include a relatively high required percentage of employees to be covered, and it must be affordable for all employees. We hope there is some mechanism that will take care of what is known as the "cliff effect"—in other words, employers that fail the test by a relatively small amount should not be treated as harshly as those that fail it by a larger amount.

We also recommend a grace period for employers who fail the test inadvertently, a time period for them to get their plans back in compliance without paying any penalty.

We believe the most reasonable affordability test is one that allows employees to participate in a future increase in health care costs, and protects against the very low income employees. For that reason, we support a percentage of the employer's premium cost as a definition of the affordable plan.

We suggest a maximum employee contribution of 40 percent of the employer's cost, but not to exceed 5 percent of the employee's wages. We want to make sure it reflects the employer's actual costs, small or large, in different regions of the country.

The design-based approach should exclude part-time workers, leased workers, until that definition has become more clear, and former employees.

The definition of "highly compensated employees" should also be changed. Small employers, those employers that don't need to deal with the existing definition of highly compensated employees, would be better served by a simple definition that looked to the W-2 form. We know it is difficult to develop a single plan for all types of benefits; we think there should be different plans for different types of benefits, different tests for different types of benefits—different tests for cafeteria plans, different tests for group term life insurance plans, and perhaps even, as Treasury mentioned, a coverage test for those employers that don't want to or cannot comply with the availability test.

Thank you.

[Mr. Skadden's and Ms. Walker's prepared statement appears in the appendix.]

The CHAIRMAN. Mr. Hansen, you are a CLU, and you are on the Task Force on Health, Federal Law and Legislation Committee for the National Association of Life Underwriters. Would you proceed?

STATEMENT OF KARL E. HANSEN, CLU, CHAIRMAN, TASK FORCE ON HEALTH, FEDERAL LAW AND LEGISLATION COMMITTEE, THE NATIONAL ASSOCIATION OF LIFE UNDERWRITERS, WASHINGTON, DC

Mr. HANSEN. Thank you, Mr. Chairman.

My name is Karl Hansen. I am here representing the National Association of Life Underwriters, an association that represents over 135,000 professional life and health insurance agents.

Like many of my colleagues, I have been trying to help my clients comply with Section 89. Unfortunately, the underlying social,

tax policy, and revenue needs that created Section 89 have proved to be extremely cumbersome in the real world of employee benefits administration. As a result, we applaud your efforts to reform and simplify Section 89.

We believe that the simplified health arrangements described in S. 654 would solve the need for simplification. We also believe that providing employers a choice between a simple but fairly rigid test, like S. 654's simplified health arrangements, and the more complicated but more flexible coverage-based tests that form the basis of current law, creates fairness for all employers. We do, however, have some modifications to suggest which we believe would make the Section 89 reform legislation more workable.

Specifically, the dollar amount affordability standard that is part of the simplified health arrangement test is potentially too rigid; it does not properly reflect the demographic and geographic realities of the marketplace.

Instead, we would recommend you offer a choice between dollar amounts and a percentage of premium, and/or compensation.

Second, although we do support the design-based test that is the basis of simplified health arrangements, we realize that oversimplification can cause plan flexibility to be severely sacrificed, and for many employers the need for flexibility outweighs the need for simplicity.

Because of this, we very much support this bill's provision of a choice between the existing coverage-based test and a simpler design-based alternate availability test.

Third, allowing employers to choose to comply with the existing testing requirements presents an opportunity, that being an incentive to provide coverage to more part-time employees. Such an incentive can be derived by allowing employers a leveraging provision to the benefits provided to part-timers. Thus, instead of the current equalizing benefit factors available for part-time employees, we would propose that the part-time factors be moderately increased to reward employers who cover such workers.

Finally, we would like to propose some definitional modifications:

First, independent contractors, when covered, should be tested as a separate line of business. Union employees should also be tested separately, as should formal retirement coverage, as compared to coverage available to former employees on a general basis.

Next, we believe that accidental death and dismemberment coverage, because it typically mimics group life insurance benefits, should be tested under the non-discrimination rules of Section 79.

NALU supports your efforts to simplify Section 89. We are, however, mindful of the potential cost. We would hope that any proposed safe-harbor approach reflect a plan design that would have typically passed the original testing parameters.

In conclusion, we reiterate our support for S. 654, as modified.

I would be happy at this time to answer any questions you might have. Thank you very much, sir.

[Mr. Hansen's prepared statement appears in the appendix.]

The CHAIRMAN. Thank you.

Mr. Richardson, you are dealing with employee benefits and working for the Employers Council on Flexible Compensation and the Cafeteria Plan Coalition. Would you go ahead, sir?

STATEMENT OF WILLIAM W. RICHARDSON, MANAGER, EMPLOYEE BENEFITS, VALERO ENERGY CORP., TESTIFYING ON BEHALF OF EMPLOYERS COUNCIL ON FLEXIBLE COMPENSATION AND THE CAFETERIA PLAN COALITION, SAN ANTONIO, TX

Mr. RICHARDSON. Thank you.

I am Bill Richardson, Employee Benefits Manager for Valero Energy Corp. in San Antonio. I am appearing on behalf of the Employers Council on Flexible Compensation, and the Cafeteria Plan Coalition.

I speak on behalf of thousands of employers who provide their employees with flexible employee benefit arrangements. Today, we ask that your simplification efforts not penalize cafeteria plans, which usually can pass the stringent non-discrimination test under the current Section 89.

Cafeteria plans allow dollars that would be wasted on duplicate coverage to be channeled toward other needed benefits such as child care. According to a 1987 ECFC survey, 97 percent of the women participating in a flexible benefits arrangement did not want to return to their previous system of imposed benefits.

The tax system should not discourage employers from providing employees with the benefits they most need or desire. Cafeteria plans are not a separate benefit plan, they are merely a delivery system for benefits.

The House Ways and Means Committee is considering legislation to simplify Section 89. In some cases, that bill would impose a tax on benefits delivered through a cafeteria plan, but not impose a tax on the same benefits when provided outside a cafeteria plan.

Mr. Chairman, we encourage you to recognize that the advantages of flexible benefits to both employees and employers are superior to any other benefits delivery system. As you work on a non-discrimination testing system for welfare benefits, we have six suggestions:

(1) Discrimination testing should be based on plan design as an alternative to reasonable participation testing;

(2) Employer-provided benefit credits should be treated as part of the employer-provided benefit, both for eligibility and for benefits testing;

(3) Salary reduction by both higher paid and lower paid employees should be treated uniformly for benefits testing;

(4) Any affordability indices should be based on medical costs and not on wages;

(5) A non-discrimination test should avoid cliff effects in testing benefits; and

(6) Dependent care assistance should be included in the simplification process.

Mr. Chairman, we at ECFC and the Cafeteria Plan Coalition will work with you and the staff in accomplish the objective to prevent bias toward highly paid and tax-favored employee benefits. Accomplishing that objective should not require that this Nation's most innovative benefits delivery system suffer. We as employers, as employees, and as a nation need the flexibility and savings that cafeteria plans can offer.

Thank you for this opportunity to share our concerns.

[Mr. Richardson's prepared statement appears in the appendix.]

The CHAIRMAN. Thank you for your testimony.

Mr. Danilson, you are associate director for Group Underwriting, The Principal Financial Group; Des Moines, IA. Would you comment, please?

STATEMENT OF RON DANILSON, ASSOCIATE DIRECTOR, GROUP UNDERWRITING, THE PRINCIPAL FINANCIAL GROUP, DES MOINES, IA

Mr. DANILSON. Thank you, Mr. Chairman.

I am Ron Danilson, Associate Director of Group Underwriting for the Principal Financial Group, headquartered in Des Moines, Iowa. We are a major underwriter of employer-sponsored life and health insurance and provide coverage for over 60,000 employer groups located throughout the United States, of which almost 50,000 are employers with 10 or fewer covered employees. Thank you for asking us to share some of our concerns about Section 89 today.

We are convinced the current non-discrimination tests are too onerous, and that their attendant rules of application are too complex for most employer group plans. Many of our smaller customers are overwhelmed with the law's complexity. They tell us they will simply have the business owner pay the tax, rather than attempt to apply the test.

We are encouraged by the efforts of Senator Pryor to simplify this law. We strongly support the concept of a plan designed safe harbor introduced by Senator Pryor as an alternative to the current rules for non-discrimination testing. We view this as an essential part of any simplification effort.

There is, however, one important element included in the design-based alternatives offered so far that we need believe needs to be reconsidered; this is the dollar cap on the amount of employee contributions allowed for the cost of the health plan. We understand the objective of the cap is to alleviate the affordability problem for low wage workers. Although we are sympathetic with this objective, a dollar cap creates a number of unintended problems.

A common characteristic for many small employer health plans is the less generous employer subsidy for dependent coverage than that normally provided for employee coverage. This is an affordability issue for small employers. A dollar cap that is too low will put the safe harbor financially out of the reach of many small employers. Without the safe harbor, there is less incentive for the small employer to subsidize dependent coverage at all.

As an alternative to the dollar cap, we suggest establishing percentage cost-sharing limits. The employee contribution could be limited to 50 percent of the total health benefits cost for the plan to qualify for the safe harbor, as one example.

Current Section 89 rules artificially impose a new definition of "part-time employee" of 17.5 hours per week, on all employers, and requires that these employees be counted in testing. Although we offer to cover employees who work as few as 17.5 hours per week, for many of our small business customers this boils down to a forced financial choice of paying tax on their own benefits, since the cost to expand coverage to part-time employees is a significant-

ly greater financial burden. We support the simplification efforts of Senator Pryor and others that exclude part-time employees who work less than 25 hours per week from testing for all employers.

We also agree that the penalties included in the original law and modified by the proposed regulations for failure to comply with qualification standards are excessive and need further modifications.

Furthermore, we strongly urge that this qualification rule change be expanded to clarify that satisfaction of the written plan rules of ERISA be deemed to be satisfaction of the written plan rules under 89. The proposed regulations appear to add a new requirement on top of existing ERISA rules, with no substantive difference in end result. These regulations will force many small, fully-insured employers to incur unnecessary additional expense for a new single written plan document that, for the most part, will refer to already existing documents for details. Employer resources, already strained by increases in health care costs, should not be required to be spent on this unnecessary duplication for no added benefits to participants.

Thank you.

[Mr. Danilson's prepared statement appears in the appendix.]

The CHAIRMAN. Thank you, Mr. Danilson.

Mr. Skadden and Ms. Walker, you all are really in the trenches, trying to apply these complex rules, so your input is particularly valuable to us.

Do you think we can really come up with legislation that achieves the objective of anti-discrimination, and do it in a simple way? Is that achievable?

Ms. WALKER. That is certainly achievable. We believe the Rostenkowski bill goes a long way toward that goal.

In listening to some of the discussions here this morning, and in talking about is there really discrimination in health benefits, I think it is important to realize that in general most employers provide health benefits for most of their employees, if they provide them for any employees. On the other hand, just like there are non-qualified deferred-compensation plans for executives, there are executive-only health plans, and perhaps we are only talking about getting rid of executive-only health plans. That would be a relatively simple test—just to the extent that the executive got something other than what the rank and file got, something available only to executives, it would be a taxable benefit. That is the ultimate in simplicity.

Will you then have large groups of employers that provide different benefits for different people? Yes. But it will not be significant discrimination, in my mind.

The CHAIRMAN. I couldn't make up my mind whether Mr. Hansen was flinching or not, when you said different plans for executives.

Mr. HANSEN. No. [Laughter.]

Senator BRADLEY. I couldn't, either, Mr. Chairman.

The CHAIRMAN. A man who has watched a lot of CLUs at work, who like to sell——

Mr. HANSEN. Oh, executive benefits?

The CHAIRMAN. Yes.

As I listen to the principal thrust of your testimony, Mr. Hansen, you were talking about testing actual coverage, and retaining that. I guess we have heard from almost all the business people in this country about the complexities. Would you tell me why you feel strongly about retaining that?

Mr. HANSEN. Well, I think it is becoming obvious here, as it did last week at the Ways and Means Committee hearing, that there will need to be a tremendous number of exceptions required to make any design-based simplified approach workable. Existing law reflects a tremendous amount of thought and effort to accommodate the flexibility that is needed for the complexity of existing coverages.

The benefits world is not a simple environment, by any means. The point is that, in certain scenarios, many employers need to be tested based on the coverage that they are actually providing to their employees, rather than on one plan design that is available to nearly all employees.

The best example was just presented. There is a small employer here in Washington, DC, known as the Federal Government. The Federal Government plan, the way it is currently constructed, I believe would not pass either one of the two proposed design-based availability tests. The point is that, there again, you are a good example, because the Federal Government has come out and budgeted a specific dollar amount that they are willing to spend, and they are telling the employees, "Okay, you have to pick up the excess."

Well, there is no reason that we shouldn't say to our small employers that they should be able to do something similar. In putting the small dollar caps—as I think Senator Durenberger made the point—we are not very close to reality right now.

So, I think a coverage-based test is necessary in a number of situations, especially in the larger, more complex arena and in the cafeteria arena, to see the value of coverage that is being provided.

The CHAIRMAN. Let me get into the cafeteria plans for a minute here.

Mr. Richardson, when we are talking about the possible reforms of Section 89, one of the concerns in this country, with two parents working, is trying to encourage child care plans. Do you see a possible endangerment of that with the reform of Section 89?

Mr. RICHARDSON. Section 89 endangers the entire welfare benefits area, which includes dependent care. I think that flexible benefits programs offer the greatest opportunity for providing dependent care throughout this country, as well as other optional benefits.

As we are all aware, there is a limit as to how much employers can pay for benefits, as there is a limit as to how much we can pay for salaries, and still stay in business. The advantage of the flexible benefits program is that you can give the dollars to the employee and give him the freedom of choice to spend his dollars where he sees they best fit. And those who find it appropriate for dependent care—and we do happen to have a dependent care assistance spending account—can use it there; or, they can use it where else it is more appropriate, if they don't have the need for dependent care, as I don't right now.

The CHAIRMAN. Mr. Danilson, you sell a lot of plans to employers who have 10 or less employees, as I understand it. You get into that, and you have got the father and the son-in-law there working, and some other in-laws, and trying to keep them all covered.

Tell me a little about the difference in the underwriting practices toward the small, small company, as practiced.

Mr. DANILSON. For the small employer—under 10 employees and, perhaps, even under 50 employees for some companies, but for our company, under 10 employees—we require a high participation percentage of the small employers full-time employees. For example, for a 10-employee company, we would require that at least 75 percent of the full-time employees participate in the plan; thus we are certain that we would get a fair cross-section of those employees participating in the plan, as opposed to only employees who may have ill health.

We also require an employer subsidy of at least 50 percent of the cost of the plan—again, so we are ensured that there will be participation. As the size of the employer decreases—for example, an employer that may have only five employees—we move that percentage up, to require 100 percent of full-time employees to participate in the plan, unless there is an exclusion because that particular employee has coverage elsewhere. Again, we seek to prevent "adverse selection," in insurance company terms.

Those types of requirements are consistent with some of three rules in Section 89, but the missing piece, with regard to our requirements that force high participation rates or require high participation rates, is that it applies to the full-time employees. The part-time employee has created some significant problems for small employers, just because of the small number of employees for those firms.

The CHAIRMAN. Thank you very much. That will be helpful to us. We appreciate that.

Our next panel consists of the Honorable Sandy Galef, a legislator from Westchester County, testifying on behalf of the National Association of Counties, of Westchester County, NY; Mr. Joseph Peery, vice president, Human Resources, Quanex Corp. of Houston, TX; Ms. Kathi Child, manager of benefits development, J.C. Penney Co., testifying on behalf of the Retail Tax Committee of Common Interest, of Dallas, TX; Mr. Donald Alexander, partner, Cadwalader, Wickersham and Taft, testifying on behalf of the U.S. Chamber of Commerce; and Mr. James Lagos, past president and member, board of directors, National Small Business United, of Springfield, OH.

Mr. Lagos, are you ready? If you are, let us hear your testimony, please.

STATEMENT OF JAMES H. LAGOS, PAST PRESIDENT AND MEMBER, BOARD OF DIRECTORS, NATIONAL SMALL BUSINESS UNITED, SPRINGFIELD, OH

Mr. LAGOS. Thank you very much, Senator Bentsen. It is a high honor and a privilege for me to be here today. I very much appreciate your holding these hearings. I also appreciate you members of the staff who are here listening, also.

I am a lawyer by training. My brother and I have a small law firm in Springfield, Ohio. We have a number of small businesses we also own; we are in the construction business, farming, apartments, warehousing. We have been in a variety of small businesses. I am also Past President of National Small Business United, immediate past president. We have some 50,000 members.

I would like to give you just some very practical experiences that we have had in Springfield, Ohio. Let me make three practical comments, and make about five or six practical solutions as to what I think can help with the problem.

First of all, the way that I see the problem is, number one, one of cost. Now, when I say "cost" I mean after-tax dollars and time lost.

Basically, when you are talking about after-tax dollars and the possibility of having your fringe benefits be taxed to the employees, and penalties on the employers, you are talking about a massive, massive disincentive for having health insurance.

I will be perfectly honest with you. My brother and I had a health insurance plans for some of our employees in one of our companies. We got rid of it in January, as soon as Section 89 became effective. Even though we are lawyers, there is no way that we can comply, as a practical matter, with it, and certainly we are not going to take the time to do that, that would be necessary to comply. That time is money—that is another practical aspect of it.

I think the IRS estimated some 9 million hours would be spent to comply with Section 89, an average of 10 hours per employer for the testing and for complying at least partially. That is a completely ridiculous estimate. I have read Section 89 numerous times and still have a difficult time understanding it, and still have a great deal of difficulty trying to apply it. I would hesitate to tell any of my small business clients—and I have many of them—that their plans comply. I would be risking malpractice if I did.

Basically, we have a system which is uncertain and unfair. It is a mine field. If you are a small business, and you have a health insurance plan under Section 89 as it exists right now, you are basically a riverboat gambler. You are taking the future of your company in your own hands by having that, and it is a risk that most small business people are not willing to take.

I wanted to thank Senator Pryor for helping to get us on the road to a design-based plan, and I wanted to make several specific comments.

First of all, whatever we come up with in terms of reform—and I testified in front of the House and Senate Small Business Committees, and all I said there was, "repeal, repeal, repeal"—if we are talking about reform, and I think our organization, National Small Business United, has moved to the point where we think reform is possible, then you have to make sure you have a design-based system. I think Congressman Rostenkowski's bill is a good step in the right direction on that.

I also wish to compliment Senator Domenici on his bill, 595, because he went to the point of having an exclusion for small businesses of under 20 people.

Four other fast comments:

First of all, in terms of penalties: The penalties we have under Section 89 right now are the economic equivalent of being shot at

sunrise. The penalties we have under Congressman Rostenkowski's bill are the economic equivalent of having one hand cut off; they are still way too large in terms of a 34 percent excise tax.

As far as the employees covered, it is still too broad, in terms of 90 percent of everybody. That simply will not work.

In terms of employee contributions, we feel the cap is unrealistic, and that the indexing to minimum wage as opposed to health inflation is inaccurate and inadequate.

As far as a lot of the technical details that I have in my testimony, we feel those aren't quite up to snuff.

I think we want to end by saying that we wish to work with you to design a reform, which I think is possible at this point, and which National Small Business United thinks is possible. I think we can do it working together. We come here today in a spirit of cooperation. I think that basically something very good can come out of these hearings.

Senator Bentsen, thank you, again, very much, sir.

[Mr. Lagos' prepared statement appears in the appendix.]

The CHAIRMAN. What you are saying is you have moved from total repeal to seeing if we can't work out something that achieves the objective but simplifies.

Mr. LAGOS. Yes, sir. That is exactly correct, sir.

The CHAIRMAN. Mr. Alexander, we have seen you many times before this committee. You have been a very distinguished public servant, and we are delighted to have you back. You are now back in the role of testifying on behalf of the U.S. Chamber of Commerce.

STATEMENT OF DONALD C. ALEXANDER, PARTNER, CADWALADER, WICKERSHAM & TAFT, TESTIFYING ON BEHALF OF THE U.S. CHAMBER OF COMMERCE, WASHINGTON, DC

Mr. ALEXANDER. That is right, Mr. Chairman, and I greatly appreciate being here.

Mr. Chairman, the Chamber has supported repeal, but the Chamber also supports your goal, and the goal of this committee and the corresponding committee in the House, of non-discrimination in health benefits, group life benefits, and other welfare benefits. How do we achieve both goals?

Chairman Rostenkowski's bill would limit Section 89, as modified, to health benefits. He found, and rightly so, that the group life insurance provision, Section 79, already contains an anti-discrimination rule.

What was lacking in prior law was a non-discrimination rule for insured health benefits, and that is a very important factor, of course. The Chamber does not suggest a return to prior law without remedying that defect.

Now, the 90-percent rule—as has been pointed out earlier this morning—is more than a non-discrimination rule, Mr. Chairman; it is a rule of mandatory coverage. It is a rule that has very serious "cliff" problems, as the Treasury has pointed out this morning.

And we hope that this committee, when it works its major surgery upon Section 89, will review the pension examples to see whether they work, and whether they can work in this area. In the

pension field, benefits aren't mandated; instead, there is a comparability test, which is a true test for non-discrimination.

When you review Section 89 and decide upon whether you want to defer it for a while, to see what would be a better, workable alternative, I hope that you will take a careful look at collective bargaining plans, and see whether those plans really provide the opportunity for discrimination, that is the basis for this committee's concerns, that lead to Section 89. Senator Packwood, of course, said this morning that it is not particularly important as a review of multi-employer plans, because the penalties that my friend on my right so vividly described simply don't work when applied to the employer or to the employees in a multi-employer context.

Thank you.

[Mr. Alexander's prepared statement appears in the appendix.]

The CHAIRMAN. Ms. Child, if you would, proceed, please.

STATEMENT OF KATHI CHILD, MANAGER OF BENEFITS DEVELOPMENT, J.C. PENNEY CO., INC., TESTIFYING ON BEHALF OF THE RETAIL TAX COMMITTEE OF COMMON INTEREST, DALLAS, TX

Ms. CHILD. I am Kathi Child, Manager of Benefits Development for the J.C. Penney Co. I will summarize the written statement submitted for the record on behalf of the Penney Co. and seven other general merchandise retailing companies which are members of the Retail Tax Committee of Common Interest.

Mr. Chairman, the Retail Tax Committee members are pleased to express our strong support for both the general direction and specific substantive provisions of the Section 89 simplification measures. We commend the design-based approach, which is used by both bills and which would result in a much less complex and administratively burdensome statute.

To provide the context in which our proposal is related to the 90-percent eligibility test, or may, I will briefly describe the retailing workforce.

The larger RTC members employ 300,000 to 500,000 people during a normal year. Some 50 to 60 percent of our employees work part-time, meaning they work less than 40 hours per week. Most of these part-timers are second wage-earners in a household, "moonlighters," students and retirees, who look to other employers for health care. Retailing also experiences very high new-employee turnover.

These facts present our management with serious problems. Full-time employees are eligible for health care plans of RTC companies, but they may comprise as little as 25 percent of the workforce. To offer coverage to part-timers who either are likely to leave within a few months or who will work relatively few hours during the week, or will work only at certain seasons, and almost certainly have coverage from another employer, would be extremely expensive, while it would serve no business or public policy purpose.

Both bills are commendable for raising the excludable part-time employee standard to 25 hours, which is more realistic than the

17.5-hour standard. Senator Pryor's 3-year phase-in from 30 hours to 25 hours should also be adopted.

However, there are three other matters which we urge be addressed with respect to the 90-percent test.

First, the exclusions for certain groups of employees should not be denied simply because one employee in such a category is eligible under a plan. This is particularly the case with respect to part-time employees, who may be eligible because they have become members of a company's permanent workforce.

Our second recommendation concerns the current Section 89 rule allowing for separate testing of excludable employee groups for compliance, in lieu of complete denial of the exclusion. We understand that this rule was enacted to mitigate the harshness of the all-or-nothing exclusion, and we urge that it be retained.

Third, we recommend two options for mitigating the severity of the 90-percent test. One approach is to lower the eligibility threshold to something in the 70- to 80-percent range. There are precedents for these percentages. However, any fixed threshold presents a "cliff effect" with respect to the highly-compensated employees' tax penalty. An alternative would be to lower the threshold and use a simple sliding scale for these exclusions.

In summary, Mr. Chairman, the RTC companies commend you and this committee for revisiting Section 89. We urge that our recommendations be included in the final version of Section 89, and we look forward to working with this committee to create that final version this year.

[Ms. Child's prepared statement appears in the appendix.]

The CHAIRMAN. Thank you.

Mr. Peery?

STATEMENT OF JOSEPH K. PEERY, VICE PRESIDENT, HUMAN RESOURCES, QUANEX CORP., HOUSTON, TX

Mr. PEERY. Thank you, Chairman Bentsen.

I am Joseph Peery, vice president of human resources for Quanex Corp. We would like to express our appreciation to the chairman for holding these hearings, and also to Senator Pryor for taking a leadership role in introducing Senate bill 654.

Quanex Corp. is a Houston-based, half-million dollar steel company, with nine operating plants located in Texas, Arkansas, Michigan, Indiana, and Nevada.

The Quanex philosophy has always been to provide its employees the best benefits the company can afford. We want our employees thinking about their jobs, not unpaid medical bills. We offer our employees an excellent comprehensive medical package at no premium cost to the employee. Deductibles and co-pays are even geared to lower-paid employees. In addition, we offer the popular HMO plans that give, essentially, first-dollar coverage. For example, in our Arkansas location we have a young workforce, with family needs that are best served by the HMO concept. The employee may choose this type of coverage, which sometimes is more expensive, by paying the difference in cost.

By offering these choices, we provide employees a valuable option; and yet, we may not pass the current non-discrimination

test, or even fall within Senator Pryor's safe harbor proposal, because some employees choose to pay for first-dollar HMO coverage while others do not.

Quanex has recently returned to profitability, after some tough years, and we have a lean and competitive operation. With 2,000 employees, half covered by union contracts, our benefits staff consists of one professional benefits manager and two clerical personnel. Under the current Section 89 law, we have over 100 benefit plans with which to contend, and we don't think it should be necessary to add more staff or hire consultants in order to comply with the law.

We think Senator Pryor is on the right track, and with some improvements his bill could provide some real relief. For example:

Coverage and affordability requirements should be modified, first of all to define affordability, allow use of a percentage of an employee's compensation, say 4 to 5 percent, to define affordability, rather than a dollar amount;

Second, if you stay with the dollar-amount definition of affordability, index it, using only the medical cost component of the CPI;

Third, allow supplemental plans such as HMOs to be offered without prejudice to the base plan; and, finally,

Exclude or test separately all collectively bargained plans.

In short, if an employer offers affordable basic health care to 90 percent of his workforce, he should bypass Section 89 altogether, even if he offers other health care options which an employee may choose to pay more for out of his own pocket.

We applaud your efforts to fix this problem, and we urge you to keep simplification foremost in your thinking.

Thank you for this opportunity to be heard.

[Mr. Peery's prepared statement appears in the appendix.]

The CHAIRMAN. Ms. Galef, we are pleased to have you.

STATEMENT OF SANDY GALEF, LEGISLATOR, WESTCHESTER COUNTY BOARD OF LEGISLATORS, VICE CHAIR, NATIONAL ASSOCIATION OF COUNTIES' LABOR AND EMPLOYEE BENEFITS STEERING COMMITTEE, TESTIFYING ON BEHALF OF THE NATIONAL ASSOCIATION OF COUNTIES, WESTCHESTER COUNTY, NY

Ms. GALEF. Thank you, Mr. Chairman.

We appreciate the opportunity to testify.

I am Sandy Galef, a legislator from Westchester County, New York, and vice chair of the Labor and Employee Benefits Steering Committee for the National Association of Counties. I am pleased to be here on behalf of NACO and its member counties to provide our views on the proposed Section 89 Simplification Act.

Mr. Chairman, we have heard three explanations for why Congress enacted the current Section 89 legislation. We have heard it was enacted to discourage discrimination in tax-exempt benefit plans, to expand health insurance coverage to the uninsured, and some have said it was enacted to raise revenues. In any event, we are not convinced that it will accomplish any of these objectives. Instead, in order to avoid compliance problems, Section 89 has

caused many employers to seriously consider dropping or reducing health benefits for their highly-compensated employees.

As a revenue-raiser, we believe cost of compliance will far exceed any increased revenues that can be anticipated from Section 89. Because we do not discriminate, and because counties are the payors of last resort for uninsured indigents, NACO strongly favors State and local exemption from Section 89. Our track record in providing equal benefits to our employees and the safeguards against discrimination in the public sector will demonstrate that Section 89 is unnecessary in State and local governments.

Let me point out that we fully support not only the concept but the practice of non-discrimination in employer-provided tax-exempt benefit plans. If you examine the facts, you will find that State and local governments have for many years offered their employees the same level of benefits, regardless of income.

In Westchester County, we offer all of our employees the same health benefits. We pay the full cost of both individual and family coverage. Under current law, we are still required to pass the complicated non-discrimination test. Clearly, this is a waste of valuable staff time and taxpayer money. There are more than enough safeguards in the public sector to protect our employees from discrimination. As elected officials, our policy and practice are always open to public scrutiny. If we exercise poor judgment, our voters don't mind showing their disapproval when we face them at the ballot every 2 to 4 years.

Counties stand to suffer financially when either our employees or residents go uninsured or under-insured. In 31 States, counties are mandated by law to pay the cost of health care for uninsured indigents inside their boundaries. Consequently, there is every incentive for us to offer adequate health care coverage to our employees and encourage other employers to do likewise.

We want to commend you and members of the committee for holding this hearing to examine the impact of Section 89 on public and private sector employees. The complicated testing requirements have already forced many counties to hire tax consultants to help sort through an enormous amount of records, to determine if we are able to comply with the non-discriminatory rules.

We also commend the sponsors of the Section 89 Simplification Act. In our view, it will offer a reasonable alternative to the complicated testing requirements.

We especially appreciate the exemption for local government and private non-profit agencies that do not have highly compensated employees.

Overall, we feel the Simplification bill would be a first step in the right direction. However, there are a few improvements we would like to see adopted in this bill:

We appreciate the safe harbor created in the bill that would allow employers to design their health plans to preclude the need for non-discrimination testing. While this simplified health insurance arrangement might be an attractive alternative, we feel the limits on employee contributions for individual and family coverages are much too low. These levels do not reflect the employer-employee cost-sharing that now exists, nor the fact that health care

costs generally increase much faster than the Consumer Price Index.

We also hope that you replace the nondiscrimination rules with a simplified rule for employers that cannot comply with the simplified health arrangement.

In summary, we, again, feel that State and local governments should not be a part of the 89 regulations.

Thank you.

[Ms. Galef's prepared statement appears in the appendix.]

The CHAIRMAN. Are you saying you don't think we should have the same standards for State, local, and Federal employees?

Ms. GALEF. Well, I believe that State and local employees, according to your own Bureau of Labor Statistics from 1987 said that 94 percent of full-time employees are covered with health benefits, and 85 percent have been covered with life insurance benefits. We feel that there has really been no proven discrimination in county governments; and, until that discrimination has been shown to us, we feel that we should be excluded.

Again, we are very public. We are elected officials. The union representatives come to us; they come to public hearings. We can be elected out of office if we do not comply and meet the acceptable standards within our counties.

The CHAIRMAN. Ms. Galef, I was a county judge once upon a time, so I understand where you are coming from.

Ms. GALEF. You know.

The CHAIRMAN. Mr. Peery, as I understand you, you still feel that there should be some non-discrimination rules; but in the proposals you have seen, there are some problems you have to work out in trying to get to simplification. Does that pretty well say it?

Mr. PEERY. Yes, that is correct, Senator Bentsen. We just feel like some sort of an expanded safe harbor that can cover the majority of companies like Quanex is the simplest solution.

The CHAIRMAN. Ms. Child, I really appreciate your changing your plans and coming up on short notice.

You were talking about the "cliff" problem.

Ms. CHILD. Yes.

The CHAIRMAN. One of the problems we have is in trying to give the employer and the employees more flexibility. We agree that a complexity has been added to the plans.

I heard you say the "relatively simple sliding scale," but it didn't look so simple to me. Aren't you really adding some more complexity with that?

Ms. CHILD. In the sense that for those retailing companies in particular who find it economically impossible to cover 90 percent of their workforce, we would propose a little bit higher tax on their highly compensated persons then, the company can make the decision to offer the coverage on the 90-percent level, or even higher. If they happen to cover only 89 percent, the sliding scale would give them a little more flexibility to design a program that fits their needs.

The CHAIRMAN. Mr. Alexander, in your testimony you touched on multi-employer plans. I can see it must be a horrendous problem, trying to collect the data on multi-employer plans when employees move from one to the other. I suppose it is like movies

being made, acting, that sort of thing, where they go from one to another. It would be very difficult to assemble that kind of data. Are you talking about an exclusion there?

Mr. ALEXANDER. Exclusion is probably the only really good course, Mr. Chairman. I guess, first, is there a problem there?

The CHAIRMAN. But I would assume that there is a lot of bargaining that takes place when you have got a multi-employer plan.

Mr. ALEXANDER. Of course. And the employer who contributes to a multi-employer plan contributes so much an hour, Mr. Chairman, and the plan, then, is responsible for everything that happens after that contribution is made—what benefits, to what people, in what form.

The employer has no right to obtain the information that the employer would have to have in order to comply with the current Section 89, and, for that matter, in order to comply with the bills, that are good steps in the right direction, to try to remedy Section 89.

The 89-K requirements imposed on the employer under Chairman Rostenkowski's bill, at a 34 percent rate, penalty tax, would create a monstrous problems for employers contributing to multi-employer plans.

On the other hand, the plan administrator and the plan trustees are those responsible for administering the plan; but they don't have all of the information, either. The employer has the employee's W-2. The plan administrator and the plan trustees know how much has come into the plan from a particular employer.

The CHAIRMAN. I see my time has expired.

Senator Symms?

Senator SYMMS. Thank you very much, Mr. Chairman. Again, I would like to thank you for these hearings today, and personally thank all of the witnesses that made this hearing what I consider to be a success.

Mr. Chairman, I would like to ask unanimous consent that the testimony of Blake Hall, representing the Idaho Association of Counties, be inserted in the record at this point.

The CHAIRMAN. Without objection, it will be done.

Senator SYMMS. I think, at this point, with Ms. Galef's testimony, it would be appropriate.

[The prepared statement of Mr. Blake Hall appears in the appendix.]

Senator SYMMS. I appreciate the comments the witnesses have made, and I think that we have plenty of work to do on this committee. I thank all of you for your input, and we will look forward to continued input as mark-up commences on this.

Thank you again, Mr. Chairman.

The CHAIRMAN. Senator Pryor?

Senator PRYOR. Yes. Mr. Chairman, I will just take a moment.

Senator SYMMS. Excuse me.

Senator PRYOR. Yes.

Senator SYMMS. I also have the statement of the Mayor of Rupert, ID, and I would ask unanimous consent that that be included in the record, also.

The CHAIRMAN. Without objection, that will be done.

[The prepared statement of the Mayor of Rupert, ID, appears in the appendix.]

Senator PRYOR. Mr. Chairman, I will just take a moment. I want to say thanks to Mr. Lagos—am I pronouncing it right?

Mr. LAGOS. Lagos. It is a Greek name, sir.

Senator PRYOR. Of the Small Business United. In my opinion, you have taken an extremely reasoned and responsible position. And from a very large number of those who are members of your particular association, you must be getting a lot of pressure, as we all do, to repeal Section 89. I really want to thank you for your very, very fine role of leadership in trying to see if we can simplify this.

I know you have some problems with simplified health arrangements. You suggested that you might have some problems there. I wonder if you might have any immediate solutions to that.

Mr. LAGOS. Basically, in terms of the reforms necessary to reform Section 89?

Senator PRYOR. Yes.

Mr. LAGOS. We have about three or four of them.

In terms of the employees eligible—okay?—we would like for us all to have an exemption, as Senator Domenici proposed in 595, which is a 20-employee exemption.

We would suggest, in terms of the other companies, "90 percent" should be "90 percent of those who are insurable, rounded down to the next lowest number."

We would recommend that the costs we have here of $10 per week that was proposed by Congressman Rostenkowski for single individual coverage, and $25 per week for family coverage, be the greater of those amounts, or 5 percent of the gross income in terms of single individuals and 12 percent for families.

We would recommend that what we have to do is get rid of the penalties. When you have a 34 percent excise-tax penalty on there—you know, there are a lot of small corporations, for example, that make $25,000 a year. They are paying taxes, corporate taxes, at the rate of 15 percent; and you are hitting them with a 34-percent penalty on their premiums, which is a savage penalty. It is a great improvement—we don't have to worry now under some of the reforms proposed that the employees are going to get kicked in the head—but, basically, the employers are being hit with a very heavy penalty for, essentially, ignorance.

When we had the I-9 forms come out concerning immigration law reform, the Justice Department, the INS, sent out hundreds of thousands of copies of I-9 forms to employers all over America. That hasn't happened in the case of Section 89. There are vast numbers of small businesses out there that simply do not know that it exists.

We think that, basically, these are technical types of improvements that can be made.

Senator Pryor, you weren't here when I made the comments. I did want to thank you specifically for getting us started on the road to a design-based Section 89 in the bill that you sponsored, Senate Bill 654. Basically, I think that was a start, frankly, on our position at the National Small Business United.

When I testified in front of the House and Senate Small Business Committees, at that point I was still saying "repeal," but that got us thinking in terms of "reform." And we thank you very much for your good efforts, sir.

Senator PRYOR. Good. I want to thank you. And any further suggestions you have, I assume that we can have those placed in writing.

Mr. Chairman, this has been a very constructive hearing. We have received a lot of good suggestions this morning. I don't think anyone has the magic solution.

In closing I would like to say I apologize for not being here for this panel of witnesses. I was on the Senate floor.

Mr. Peery is a constituent of yours, but Quanex is a very fine corporate citizen of the State of Arkansas. They have a splendid steel mill there in our State, in Fort Smith, and are soon announcing a $30 million expansion. It is the state of the art. I have been through that particular facility, and we are very proud to have you as a corporate citizen of Arkansas.

With that said, I know the design-based approach helped. You stated that you have some problems with HMOs. If you would like to just submit that answer for the record, some suggestions, in the interest of time, I know the committee would appreciate it.

Mr. PEERY. Thank you for those comments, Senator Pryor.

Senator PRYOR. Thank you all.

The CHAIRMAN. Thank you, Senator.

I would say, Mr. Lagos, that I think Senator Pryor has made a good point. As you testified early on, in January you and your brother canceled your plan—far too many problems with it.

Mr. LAGOS. That is correct, sir.

The CHAIRMAN. And that is the easy out.

Mr. LAGOS. That is correct.

The CHAIRMAN. But, here, we are trying to find equity, and trying to see that a plan is made to conform and comply, to bring about that kind of equity, and I am delighted to see the stand of your association in trying to work toward that end.

Mr. LAGOS. Thank you, Senator.

The CHAIRMAN. I think what we have heard this morning has been very helpful to us. We have seen how difficult the problem is, but I think it is one that we can make major progress on with the kind of input that we are hearing here today. I want to accelerate the process, and I really want the Executive Branch coming up with their suggestions and making them a part of this.

If you come up with some additional ideas, we will be delighted to have them. If you will send them to us, we will consider them for the record in the hearings.

Thank you very much for your attention.

Mr. LAGOS. Thank you, Senator.

[Whereupon, at 12:18 p.m., the hearing was concluded.]

APPENDIX

Alphabetical Listing and Material Submitted

Prepared Statement of Donald C. Alexander

My name is Donald C. Alexander, and I am testifying today on behalf of the U.S. Chamber of Commerce. I am a member of the Chamber's Taxation Committee, a former member of its Board of Directors, and a partner in the law firm of Cadwalader, Wickersham & Taft.

The Chamber is the world's largest federation of business companies and associations and is the principal spokesman for the American business community. It represents nearly 180,000 businesses and organizations such as state and local chambers of commerce and trade and professional associations. More than 92 percent of the Chamber's members are small business firms with fewer than 100 employees. Fifty-nine percent have fewer than 10 employees.

The subject of today's hearing, employer-provided health benefits, is critically important to the Chamber and its member companies. For many of these companies, health benefits are the largest component of labor costs after salaries and pensions. Those employers who are committed to providing health benefits to their employees have had to struggle in recent years with a dramatic escalation in the cost of medical care and medical insurance. The escalating cost of medical insurance has hindered the spread of employer-provided health coverage to certain categories of employees and certain lines of business.

While we may all agree that adequate health insurance for every American is a worthy goal, the subject of today's hearing is limited, I believe, to the issue of discrimination. Many employers would resist federally mandated health insurance coverage, but most of them would agree that the exclusion of employer-provided health benefits from an employee's gross income cannot be defended if the benefits are limited to a small group of highly compensated employees.

It may be safe to predict that today's hearing will reveal a consensus on two fundamental points. First, highly compensated employees should not derive tax benefits from employer-provided health plans that discriminate against rank-and-file employees. Second, the antidiscrimination rules contained in section 89 of the Internal Revenue Code are not workable and must be replaced. As Chairman Bentsen stated in the Senate on April 12: "Something has to be done about the Section 89 rules. Major surgery is needed and it is needed as quickly as possible."

The Chamber thanks Chairman Bentsen for holding today's hearing and for allowing us to testify. We are grateful to Senator Pryor, Senator Symms and many other members of this Committee who have set the stage for reform of section 89 by sponsoring legislation to eliminate or modify the worst features of present law.

The position of the Chamber is that section 89 ought to be repealed. This does not mean that we favor an Internal Revenue Code without nondiscrimination requirements. What it means is that we favor a return to the basic rules that applied before section 89 was enacted. The discussion that follows reviews some, but not all, of our concerns and recommended solutions.

I. NONDISCRIMINATION RULES

Section 89 applies to health benefits and group term life insurance. If the employer so elects, it also applies to dependent care and other benefits that an employer can provide on a tax-free basis.

Some of those who want to retain section 89 speak as though discrimination was both permissible and widespread before section 89 was enacted. This was not the case. The benefits that are now subject to the rules of section 89 were already sub-

ject to nondiscrimination requirements. The only exception under prior law was for health benefits that were provided through an insurance company rather than by the employer.

The Chamber would agree that the prior-law exemption of insured health plans from nondiscrimination testing was an anomaly. The Chamber would support extending the rules that applied before section 89 was enacted to cover all health benefits, whether or not provided through an insurance company. We note, in this regard, that the section 89 simplification bill (H.R. 1864) introduced by Chairman Rostenkowski in the House would replace section 89 with prior law for all employee welfare benefits, other than health benefits. If the rules of prior law provide adequate protection against discrimination for group term life insurance, dependent care assistance, group legal services, and other employee welfare benefits, why should they not work for health benefits?

Restoring the nondiscrimination requirements that applied before section 89 was enacted, and extending them to insured health benefits, would not make it easier to discriminate, but would eliminate the provisions of current law that have made section 89 so objectionable and controversial.

A major objection to section 89 is the requirement that 90 percent of rank-and-file employees be eligible to participate in any plan offered by the employer. This is not a nondiscrimination requirement; it is a requirement for universal coverage.

The Chamber does not object to the concept that rank-and-file employees must have an opportunity to participate in any tax-favored benefit plan. However, prior to enactment of section 89, the concept of nondiscrimination meant that the percentage of highly compensated employees eligible to participate should not be unreasonably different from the percentage of non-highly compensated employees eligible to participate.

Consider, for example, an employer that owns a shoe factory and provides health benefits to all of the rank-and-file workers as well as to the highly compensated factory managers. Assume that this employer purchased another shoe factory and that neither the managers nor the workers at the second factory are receiving health benefits. The health plan provided at the first factory would continue to satisfy traditional nondiscrimination tests if, taking the two factories together, the percentage of highly compensated employees eligible for health benefits was roughly comparable to the percentage of rank-and-file employees who were eligible. However, under Section 89 the employer could not satisfy the nondiscrimination rules unless he dropped the health plan in the first factory or expanded the health plan to include the second factory. This does not seem right to us. A health plan that covers 50% of the highly compensated and 50% of the rank and file is not a discriminatory plan and should not be penalized as a discriminatory plan.

Some employers can afford to provide health benefits to all of their employees. Some employers cannot afford to provide health benefits to any of their employees. The message implicit in the 90% test is that, if you cannot afford to provide health coverage to all of your employees, you might as well not provide it to any; just increase the pay of the highly compensated and let them buy individual coverage.

Is this really the message that Congress wishes to send? The first step for an employer that provides no coverage at all may be to adopt a plan for 30%, 50%, or 70% of its employees. As long as the coverage is extended to roughly comparable percentages of rank-and-file and highly compensated employees, a plan that covers 30%, 50%, or 70% of employees should not be subject to tax penalties. *The Chamber therefore believes that the 90% test should be replaced by the traditional nondiscrimination requirement that the percentage of highly compensated employees eligible to participate not be unreasonably different from the percentage of rank-and-file employees who are eligible.*

The traditional approach to nondiscrimination testing is embodied in the rules that govern pension plans and other qualified plans that defer compensation. Under these rules, for example, a savings plan will satisfy the statutory coverage requirement if the percentage of non-highly compensated employees eligible to participate is not less than 70% of the percentage of highly compensated employees who are eligible. Any qualified plan that actually benefits at least 70% of non-highly compensated employees will automatically satisfy this requirement. (See I.R.C. §410(b)(1)(A), (B).)

The 90% test of section 89 measures whether eligibility for a health plan is universal, not whether it is discriminatory. The pension plan rules, in contrast, were specifically designed to measure nondiscrimination. We therefore urge the Committee to adopt those rules as the model for section 89. *Specifically, any group of comparable health plans should satisfy section 89 if 70% of non-highly compensated employees are eligible to participate or if the percentage of non-highly compensated em-*

ployees who are eligible is at least 70% of the percentage of highly compensated employees who are eligible.

According to the report of the Senate Committee on Finance on the 1986 Tax Reform Act, the reasons for enacting section 89 are very simple. (S. Rep. No. 313, 99th Cong., 2d Sess. 650–51 (1986).) First, as we have already mentioned, the exemption of insured health benefits from nondiscrimination testing was an anomaly. This anomaly could have been, and still can be, eliminated by extending to insured health benefits the rules that applied to uninsured health benefits before enactment of section 89. Second, there was no precise definition of "highly compensated employee." While there are some problems with the definition adopted in 1986, they are very minor compared to the problems generated by section 89 itself. Finally, the Committee's report notes that the coverage requirements of prior law were not sufficiently specific. The lack of specificity in the coverage rules was also true in the pension plan area. Congress remedied the lack of specificity in that area by adopting the 70 percent rules described above. In retrospect, we believe that the remedy applied to pension plans was far more realistic and workable than the monstrous complexity of section 89.

It may be that in certain circumstances comparing the percentage of highly compensated and non-highly compensated employees who are eligible for coverage will not be a complete solution to the problem of discrimination. Concern has been expressed that mandatory employee contributions could be so high that rank-and-file employees could not take advantage of the opportunity to participate. Also, if employees in the same company are covered by substantially different types of health plans, difficult questions of whether the benefits are "comparable" may arise. Congressman Rostenkowski's legislation seeks to handle these situations by placing a dollar limit on employee contributions and taxing highly compensated employees who participate in plans that are more than 33% more valuable than the lowest-cost health plan available to rank-and-file employees. We believe, however, that the simplest solution to problems of utilization and comparability is to look at which employees actually receive plan benefits. Section 89, for example, currently imposes tax penalties on highly compensated employees unless, on average, the benefits received by rank-and-file employees are at least 75% of the benefits received by highly compensated employees.

The Chamber believes that dollar limits on employee contributions are unnecessary and could quickly become obsolete as a result of escalating health insurance premiums. As a means of testing whether rank-and-file employees are truly benefiting from the plans for which they are eligible, the Chamber believes that the benefits test of current law may be a better approach than imposing limitations on cost-sharing between employers and employees. The 75% threshold of current law, however, is unrealistic and should be reduced to 50%. There are a number of reasons why highly compensated employees are more likely to elect higher levels of coverage than employees who are not highly compensated, including the fact that highly compensated employees are generally older and more likely to suffer health problems than other employees. Moreover, a benefits test of this sort should not be mandatory, as under current law. Instead, it should serve as an alternative means of proving nondiscrimination when an employer cannot satisfy eligibility requirements on the basis of plan design alone.

II. QUALIFICATION RULES

The other highly objectionable feature of section 89 that would be eliminated by a return to prior law is the draconian tax penalties imposed with respect to any plan that fails to satisfy five so-called "qualification" requirements. These requirements are: (1) the plan must be in writing; (2) an employee's rights under the plan must be legally enforceable; (3) employees must be given reasonable notice of plan benefits; (4) the plan must be for the exclusive benefit of employees; and (5) the plan must have been established with the intention of being maintained for an indefinite period.

While at first glance these five requirements may seem simple enough, the March 7, 1989 proposed regulations required almost 50 pages to describe them. In these proposed regulations, the Internal Revenue Service (IRS) has construed the requirement that a plan be in writing as authority for the IRS to mandate much of the contents of the written plan. For example, the proposed regulations require that the plan include a recitation of the five qualification requirements. (Prop. Treas. Reg. 1.89(k)–1, Q&A 3(c)(2).) This requirement alone will mean that virtually every health benefit plan in the United States must be rewritten.

Based upon the statutory requirement that the plan be legally enforceable, the proposed regulations have even intruded on basic features of health plan design. For

example, the proposed regulations provide that the provision of any alternative medical care under the plan must be based upon the consent of the employee, presumably regardless of how costly is the form of medical care preferred by the employee. (Prop. Treas. Reg. Sec. 1.89(k), Q&A 4(b)(2)(iii)(B).)

Although the Chamber has the greatest respect for the attorneys who staff the IRS Office of Chief Counsel, we question whether it is wise to transfer broad regulatory authority over the design and content of the nation's health programs to them. As the proposed section 89 regulations demonstrate, there are some matters too important to be left to the regulators.

The Chamber therefore recommends that the five qualification requirements of section 89 be eliminated. The requirements that the plan be for the exclusive benefit of employees and that the employer have an intention to maintain the plan for an indefinite period of time serve no meaningful purpose other than imposing yet another layer of complexity on employers seeking to understand and obey the rules. The requirements of a written and legally enforceable plan document and of reasonable notice to employees are already contained in the Employee Retirement Income Security Act (ERISA). No convincing reason has been advanced for duplicating these ERISA requirements under the Internal Revenue Code and for imposing a severe new tax penalty on top of the penalties and remedies presently provided under ERISA.

If the Committee decides to retain any of the qualification requirements under the Internal Revenue Code, then the authority of the IRS to embellish the requirements via regulation should be strictly limited by the statute or by pertinent legislative history and employers should have the opportunity to cure without penalty any defects in the plan that are not the result of negligence.

III. COLLECTIVELY BARGAINED PLANS

Section 89 requires that employees covered by a collectively bargained plan be tested together with other employees receiving the same type of benefits. This rule is impractical and unworkable in many situations. Employers have only partial control, and sometimes virtually no control, over the benefits paid under a collective bargaining agreement. There are many instances in which collective bargaining might result in unionized employees receiving more benefits or fewer benefits than employees not covered by the collective bargaining agreement.

Separate testing, as provided in Chairman Rostenkowski's bill, would solve this problem to some extent. However, separate testing is not appropriate in all circumstances. For some employers, substantially all rank-and-file employees may be covered by collective bargaining agreements. In that situation employers may need to count the union employees in order for their non-union plans to satisfy the nondiscrimination requirements. *The only rule that will be workable for the majority of employers is one that allows an employer the option of excluding employees from testing whenever they have bargained collectively over health benefits.*

The collective bargaining process provides ample protection against discrimination for the employees covered by the collective bargaining agreement. If an employer can satisfy the nondiscrimination requirements without taking these employees into consideration, the goal of simplification is advanced by freeing the employer from the requirement of collecting data with respect to employees covered by the union plan. On the other hand, if the employer needs to take the unionized employees into account and is able and willing to incur the cost of collecting the necessary data to show that the employer's plans are nondiscriminatory when union members are taken into account, the employer should have that option. Adopting our first recommendation might remove the need for an option to include such employees.

IV. MULTIEMPLOYER PLANS

Regardless of how the Committee decides to deal with collectively bargained plans in general, there is a certain category of collectively bargained plans that cries out for attention. These are the multiemployer plans covered by the Taft-Hartley Act. Under these plans, an employer negotiates with a union over the dollar amount that will be contributed to the multiemployer plan for each hour a covered employee works for that employer. The employer does not bargain over, and does not know, how his contribution will be divided between health and other benefits. The allocation of the employer's contribution between health and other benefits, the selection of the health benefits that will be provided, and the administration of the health plan are all under the control of the multiemployer plan trustees, who in turn are subject to regulation by the Department of Labor. An employer whose employees are covered by a multiemployer plan will find it extremely difficult or impossible to

collect the necessary data concerning the amount and type of coverage received by the employees and will have no means of ensuring that the multiemployer plan trustees administer the plan in accordance with section 89. *For these reasons multiemployer plans should be excluded from the rules of section 89 and and rules that replace them.*

V. SEPARATE LINES OF BUSINESS

Under section 89, as presently written, an employer may test employees in different lines of business separately. This is an important provision, which recognizes that competition in different lines of business may provide limits on what benefits an employer can reasonably be expected to offer his employees. However, current law imposes an arbitrary floor of 50 on the number of employees that is required to constitute a separate line of business. This floor has no justification and creates substantial problems, particularly for employers who are just beginning to enter a new line of business. *The 50-employee floor on separate lines of business should be eliminated.*

VI. LEASED EMPLOYEES

The application of section 89 to leased employees is one of the most troublesome features of current law. The partial correction in Chairman Rostenkowski's bill is a step in the right direction but does not go far enough. The proposed regulations on leased employees are a veritable jungle of confusion and controversy. The IRS has proposed to define leased employees so broadly that many independent contractors and subcontractors would be treated as "employee leasing organizations." *Until a reliable and accurate definition of leased employees can be promulgated by statute or by regulation, the Chamber recommends that the application of section 89 or any replacement rules be limited to common-law employees of the benefit plan sponsor.*

On behalf of the Chamber, I wish to thank the members of this Committee for their attention to our testimony. We look forward to working with the Committee and its staff in implementing these and other recommendations that will accommodate the goals of simplicity and nondiscrimination.

(SUBMITTED BY SENATOR LLOYD BENTSEN)

[JOINT COMMITTEE PRINT]

DESCRIPTION OF CERTAIN BILLS AND DISCUSSION OF ISSUES RELATING TO SECTION 89 NONDISCRIMINATION RULES APPLICABLE TO CERTAIN EMPLOYEE BENEFIT PLANS

SCHEDULED FOR A HEARING

BEFORE THE

COMMITTEE ON FINANCE

ON MAY 9, 1989

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

MAY 3, 1989

U.S. GOVERNMENT PRINTING OFFICE

97-338 WASHINGTON : 1989 JCS-10-89

For sale by the Superintendent of Documents, U.S. Government Printing Office
Washington, DC 20402

CONTENTS

	Page
INTRODUCTION	1
I. BACKGROUND	2
II. PRESENT LAW	5
A. Nondiscrimination Rules	5
B. Qualification Rules	13
C. Effective Date of Section 89 Rules	15
III. ISSUES	17
IV. DESCRIPTION OF CERTAIN BILLS RELATING TO SECTION 89	27
A. S. 654 (Senator Pryor)	27
B. S. 595 (Senator Domenici)	29
C. S. 89 (Senator Symms)	29
D. S. 350 (Senator Lott)	29
E. H.R. 1864 (Mr. Rostenkowski)	29
F. H.R. 634 (Mr. LaFalce)	32

INTRODUCTION

The Senate Committee on Finance has scheduled a public hearing on May 9, 1989, on issues relating to the nondiscrimination requirements for certain employee benefit plans contained in section 89 of the Internal Revenue Code. This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of present-law section 89 rules, a description of certain introduced bills relating to section 89, and a discussion of related issues.

The first part of the pamphlet is background and a summary of present-law section 89 rules and a summary of certain bills. The second part is a more detailed description of present-law section 89 rules. The third part discusses issues related to nondiscrimination rules for employer-provided accident or health plans, and the fourth part is a description of the provisions of various bills relating to section 89.

[1] This pamphlet may be cited as follows: *Description of Certain Bills and Discussion of Issues Relating to Section 89 Nondiscrimination Rules Applicable to Certain Employee Benefit Plans* (JCS-10-89), May 3, 1989.

I. BACKGROUND

Purposes of section 89

Section 89 was enacted as part of the Tax Reform Act of 1986, and became effective generally for plan years beginning after December 31, 1988. The statute imposes nondiscrimination and qualification rules with respect to certain employer-provided fringe benefit plans. Rules similar to those enacted as section 89 were originally included in the tax reform proposals submitted to the Congress by President Reagan in May 1985.[2] After enactment in the Tax Reform Act of 1986, the section was the subject of significant modification under the Technical and Miscellaneous Revenue Act of 1988 (TAMRA).

Section 89 was enacted to limit the tax expenditure related to employer-provided health coverage in certain circumstances. Employer-provided health coverage generally is excludable from the gross income of the employee receiving the coverage. This tax-favored treatment reduces the Federal income tax base and, therefore, reduces Federal budget receipts. The annual cost to the Federal Government of this exclusion is estimated to be $32.6 billion for fiscal year 1990, and the cost is projected to increase to $50.8 billion for fiscal year 1994.[3]

In enacting the Tax Reform Act of 1986, the Congress determined that the substantial cost related to employer-provided health insurance coverage is justified only if the tax benefits fulfill important public policy objectives. Increasing health coverage among rank-and-file employees who otherwise would not purchase or could not afford such coverage was identified as a primary policy objective underlying the exclusion for employer-provided health care coverage. Conversely, the Congress believed that the cost to the Federal Government of employer-provided accident and health coverage is not justified if such coverage disproportionately benefits highly compensated employees. In order to achieve this objective, nondiscrimination rules were enacted to permit the full exclusion from income of employer-provided health benefits only if the benefits are provided to required levels of nonhighly compensated employees and the level of benefits provided to highly compensated employees on average does not disproportionately exceed the average benefits provided to rank-and-file employees.

Present law

Under present law, section 89 applies nondiscrimination rules to certain types of fringe benefit plans, including employer-provided

---

[2] The White House, *The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity*, May 1985.

[3] See, Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 1990-1994*, JCS-4-89 (February 28, 1989).

health plans. There are two different methods of testing for nondiscrimination: a 4-part test and a 2-part test. An employer is not required to test under both methods and may elect either method of testing.

Under the first method of testing, four requirements must be satisfied. First, at least half of the employees eligible to participate in the plan must be rank-and-file employees. This test is designed to limit the tax-favored treatment of plans primarily covering highly compensated employees (e.g., executive-only plans).

Second, at least 90 percent of the rank-and-file employees must have available to them coverage that is at least one-half (50 percent) as valuable as the most valuable coverage available to any highly compensated employee. This test is designed to ensure that a significant percentage of rank-and-file employees have a minimum benefit available to them. For example, if the most valuable coverage available to any highly compensated employee is worth $1,000, then to pass this test, 90 percent of the rank-and-file employees must have available coverage of at least $500.

The third requirement is that the value of coverage received by rank-and-file employees must be at least 75 percent of the average value of coverage received by highly compensated employees. This test is designed to ensure that rank-and-file employees actually receive a significant portion of the tax benefits spent for health coverage.

Finally, under the 4-part test, the plan may not contain any provision relating to eligibility to participate that discriminates in favor of highly compensated employees (the nondiscriminatory provisions test).

As an alternative to the 4-part test, an employer may use a 2-part test. This test was designed primarily to provide a less burdensome method of compliance for small employers. Under this test, two requirements must be met. First, at least 80 percent of the employer's rank-and-file employees must be covered by the plan (or a group of aggregated plans). Second, the plan must satisfy the same nondiscriminatory provisions test as is applicable under the 4-part test.

In addition to the nondiscrimination rules, section 89 contains minimum qualification requirements for health plans (and certain other types of plans). These rules require that a plan must be in writing, legally enforceable, maintained for the exclusive benefit of employees, intended to be maintained indefinitely, and that employees be given reasonable notification of plan terms.

Summary of various bills

S. 654—Senator Pryor

S. 654, the Section 89 Simplification Act, introduced by Senator Pryor and others, on March 17, 1989, modifies several present-law rules contained in section 89 and, in addition, creates a safe harbor from the otherwise applicable nondiscrimination requirements of section 89 in the case of a plan that qualifies as a simplified health arrangement. A plan is a simplified health arrangement if (1) at least 90 percent of an employer's employees are eligible to participate in the plan or a plan of the same type having the same em-

ployer-provided benefit, and (2) the cost to an employee of the plan is not more than $6.70 per week ($348.40 per year) in the case of single coverage and $13.40 per week ($696.80 per year) in the case of family coverage (coverage of the employee and the employee's family).

S. 654 generally is effective for plan years beginning after December 31, 1988.

S. 595—Senator Domenici

S. 595, introduced by Senator Domenici and others on March 15, 1989, delays the application of section 89 for one year (i.e., until plan years beginning after December 31, 1990, makes section 89 inapplicable to certain employers with less than 20 employees, modifies the definition of part-time employees who may be disregarded in applying section 89, and creates an eligibility safe harbor that allows an employer to satisfy section 89 if all nonhighly compensated employees are eligible to participate in a plan as valuable as the most valuable plan available to any highly compensated employee.

S. 595 generally is effective for plan years beginning after December 31, 1988.

S. 89—Senator Symms

S. 89, introduced by Senator Symms and others on January 25, 1989, delays the effective date of section 89 for one year to plan years beginning after December 31, 1989.

S. 350—Senator Lott

S. 350, introduced by Senator Lott and others on February 7, 1989, repeals section 89.

H.R. 1864—Mr. Rostenkowski

H.R. 1864, introduced by Mr. Rostenkowski and others on April 13, 1989, replaces the current section 89 nondiscrimination rules for health plans with a single test. In general, an employer's health program passes the test under the bill if at least one plan or a group of plans providing primarily core health coverage is available to at least 90 percent of the employer's nonhighly compensated employees at an employee cost of no more than $10.00 per week ($520 per year) in the case of individual coverage, or $25.00 per week ($1,300 per year) in the case of family coverage. Further, under the bill, the maximum amount of employer-provided coverage that may be excluded from the income of any highly compensated employee cannot exceed 133 percent of the employer-provided coverage made available to 90 percent of the nonhighly compensated employees.

H.R. 1864 generally is effective for plan years beginning after December 31, 1989, with an employer election to apply the provisions of H.R. 1864 with respect to its 1989 plan year.

H.R. 634—Mr. LaFalce

H.R. 634, introduced by Mr. LaFalce and others on January 24, 1989, repeals section 89, effective as if section 89 had not been enacted in the Tax Reform Act of 1986.

II. PRESENT LAW

As enacted by the Tax Reform Act of 1986 and amended by the Technical and Miscellaneous Revenue Act of 1988, Code section 89 has two basic sets of requirements: (1) nondiscrimination rules; and (2) plan qualification requirements. In general, the nondiscrimination rules measure the extent to which health benefits (and certain other types of fringe benefits) are made available to rank-and-file employees and the extent to which such employees actually receive those benefits. These rules basically require an employer to compare benefits provided to highly compensated employees with benefits provided to the rank-and-file employees. These rules are designed to limit tax-favored treatment of employee benefits unless a significant portion of such benefits are provided to rank-and-file employees.

The qualification requirements require health plans (and certain other types of fringe benefit plans) to satisfy certain minimum basic requirements, for example, that the plan be in writing and be legally enforceable.

A. Nondiscrimination Rules

Plans subject to the nondiscrimination rules

In general, health plans and group-term life insurance plans are subject to the section 89 nondiscrimination rules. An employer may also elect to test its dependent care assistance programs under section 89 in lieu of applying the nondiscrimination rules contained in section 129 that otherwise apply to such plans. Disability benefits are subject to the rules to the extent the benefits are excludable from income under section 105 (b) or (c) of the Code. Benefits provided under nonhealth plans may not be taken into account in determining whether the employer's health plans satisfy the nondiscrimination rules.

All employer-provided health coverage is taken into account under section 89. For example, plans providing medical diagnostic procedures or physical examinations are health plans subject to section 89. Health coverage is required to be taken into account under section 89 regardless of the method by which it is provided, for example, through an insurance plan, a self-insured arrangement, or a voluntary employees' beneficiary association (VEBA).

Plans providing for short- and long-term disability benefits, wage continuation benefits, and workers compensation benefits generally are not subject to the section 89 nondiscrimination rules. Similarly, vacation pay plans of the employer are not subject to the section 89 nondiscrimination rules.

The nondiscrimination rules apply to plans maintained by all types of employers, other than plans maintained by churches and certain church-controlled organizations. Thus, section 89 applies to

plans of small and large employers, taxable and tax-exempt employers, private and public employers (including the Federal Government), and plans maintained by more than one employer (i.e., multiple employer and multiemployer plans).

Nondiscrimination tests

There are two methods by which an employer may test its plans to determine compliance with section 89: (1) a four-part testing method, and (2) an alternative, simplified two-part testing method. The employer may choose either testing method, and only needs to use one method, even if use of the other method might lead to different results under section 89.

Four-part test

In general.—The four-part testing method consists of three availability tests and one benefits test. The availability tests measure only whether an employee has the opportunity to participate in a plan. The benefits test measures whether, and to what extent, an employee is actually participating in a plan (i.e., has actually enrolled). The three availability tests are generally referred to as follows: the 90-percent/50-percent test, the 50-percent test, and the nondiscriminatory provision test.

90-percent/50-percent test.—The intent of the 90-percent/50-percent test is to ensure that almost all rank-and-file employees have a reasonably valuable plan available to them relative to the value of benefits available to highly compensated employees. Thus, the rule requires that 90 percent of all rank-and-file employees (i.e., those employees who are not considered highly compensated under the statute) have the opportunity to participate in a plan that is worth at least one-half (50 percent) as much as the plan or plans that provide the greatest value to any highly compensated employee. The value of the coverage to an employee is measured by looking only at the portion of the value that is paid by the employer. Under this test, an employer may look at all health plans to see if the rank-and-file employees have the opportunity to participate in any plan available that meets this requirement. For example, assume that the most valuable health plan available to any highly compensated employee is valued at $1,000. Under the 90-percent/50-percent test, 90 percent of the rank-and-file employees must have the opportunity to participate in a health plan worth at least $500.

50-percent test.—The 50-percent test is designed to limit the tax-favored treatment of plans that are only available to highly compensated employees (e.g., executive-only plans). Under this test, 50 percent of those employees eligible to participate in each option under an employer's health program are required to be rank-and-file employees. For example, assume that the dental plan maintained by the employer is available to 20 employees. The 50-percent test is satisfied if at least 10 of those employees are rank-and-file employees.

Plans of comparable value may be grouped together in determining whether the 50-percent test is satisfied. For this purpose, a group of plans are generally considered comparable if the employer-paid value of the lowest-valued plan is at least 95 percent of the

employer-paid value of the highest-valued plan in the group. For example, suppose an employer maintains two health plans, one with an employer-provided value of $1,000 and one with an employer-provided value of $950. These plans may be treated as a single plan for purposes of the 50-percent test. Thus, for example, these two plans would satisfy the 50-percent test if the only employees eligible to participate in the $1,000 plan are 15 highly compensated employees and the only employees eligible to participate in the $950 plan are 15 or more rank-and-file employees.

Nondiscriminatory provision test.—The third availability test is the nondiscriminatory provision test. Under this test, a plan may not contain any provision relating to eligibility to participate that (by its terms, operation, or otherwise) discriminates in favor of highly compensated employees. This test is subjective in nature and is intended to be applied in those instances in which discrimination is not easily measured under the numerical nondiscrimination tests. For example, assume that the president of a company has an extremely rare condition that is the primary benefit covered by the employer's health plan. This coverage is provided to all employees, not only the company president. The plan may meet the numerical requirements of section 89 because it covers all employees, not just the company president. However, under the facts and circumstances, the nondiscriminatory provision test may not be satisfied because it is unlikely that anyone other than the company president will ever benefit under the coverage in question.

Benefits test.—The benefits test, which is often referred to as the 75-percent benefits test, is designed to ensure that rank-and-file employees actually receive a significant portion of the total employer dollars that are spent for health benefits. An employer's health plans pass this test if the average value of all employer-provided health coverage received by the rank-and-file employees is at least 75 percent of the average value of employer-provided health coverage received by highly compensated employees. For example, if the average employer-paid portion of health coverage provided to highly compensated employees is $1,000, the 75-percent benefits test is satisfied only if the average employer-paid portion of health coverage provided to rank-and-file employees is no less than $750.

Treasury regulations contain safe harbors for 1989 and 1990 under which an employer does not have to apply the 75-percent benefits test. Instead, the employer may include as taxable income the value of health coverage received by certain highly compensated employees and satisfy certain other requirements.

Two-part test

The alternative method of determining whether an employer's plans are discriminatory is called the two-part test, which consists of the previously discussed nondiscriminatory provision test and an 80-percent coverage test. The 80-percent coverage test was developed for use by small employers with simple benefit programs. An employer passes this test if its plans cover 80 percent of its rank-and-file employees. Thus, for example, if the employer maintains one health plan providing coverage to employees and their families and 80 percent of all rank-and-file employees participate in the plan, then the employer passes the 80-percent coverage test.

Comparable plans may be aggregated for purposes of the 80-percent coverage test. In general, for purposes of the 80-percent test, a group of plans is considered comparable if the employer-paid value of the lowest valued plan is at least 90 percent of the employer-paid value of the highest-valued plan in the group. Thus, for example, a plan with an employer-paid value of $450 and a plan with a similar value of $500 are comparable because $450 is at least 90 percent of $500.

There are several variations on this general comparability rule that compare plans based on employer-provided value. In addition, plans can be aggregated if employees can freely choose among the plans, and the difference in employee cost (i.e., the portion of the cost of coverage that the employee pays) is no more than $100 per year.

Salary reduction contributions

Under present law, special rules apply to pre-tax contributions made by an employee to a cafeteria plan (i.e., salary reduction contributions). In general, except for certain purposes, salary reduction contributions are treated as employer contributions. Special rules apply to the treatment of salary reduction contributions for purposes of the 90-percent/50-percent test and for the 50-percent test. These rules are designed to permit an employer to treat salary reduction contributions as employer contributions if doing so does not permit the avoidance of the tests.

In general, an employer may treat available salary reduction contributions as employer contributions under the 90-percent/50-percent test if the ability to make salary reduction contributions is available on the same basis to rank-and-file and highly compensated employees, and the employer does not offer a benefit to its rank-and-file employees primarily on a salary-reduction basis, while offering the same benefit to highly compensated employees on an employer-paid basis.

Notwithstanding these general rules, the Secretary of the Treasury is authorized to establish rules under which salary reduction shall or shall not be taken into account as an employer-provided benefit to prevent avoidance of the nondiscrimination rules. These rules are to take into account the fact that salary reduction contributions provide a tax-benefit to high-paid employees, but represent employee cost for low-paid employees. Consequently, these rules may also permit salary reduction to be characterized differently with respect to highly compensated and rank-and-file employees.

The exclusion of salary reduction contributions of high paid employees may create inappropriate results if such employees can receive a significant portion of their benefits through salary reduction. For example, suppose a highly compensated employee can purchase $5,000 of health benefits through salary reduction. If salary reduction is disregarded, the employee will be treated as receiving no benefit for purposes of the 90-percent/50-percent test. This treatment is inappropriate because the salary reduction contributions are a significant tax-favored benefit.

On the other hand, the inclusion of salary reduction may create inappropriate results if a significant portion of the rank-and-file are required to purchase a significant portion of their benefits

through salary reduction because at some level of contribution, salary reduction is not effectively available to the rank-and-file because of its cost.

The Secretary of the Treasury has issued regulations providing that, in computing the largest benefit available to a high-paid employee for purposes of the 90-percent/50-percent test, the health coverage attributable to salary reduction is considered an employer-provided benefit and is taken into account to the extent that the portion of core health coverage attributable to salary reduction exceeds 100 percent of the core health coverage attributable to employer contributions (excluding salary reduction).

The regulations also provide that, in computing the benefit available to a rank-and-file employee, core health coverage attributable to salary reduction is considered an employee contribution and is disregarded to the extent that the portion of core health coverage attributable to salary reduction exceeds 100 percent of the core health coverage attributable to employer contributions. This rule only applies when the employer has elected to consider salary reduction as employer contributions for purposes of the 90-percent/50-percent test.

The Treasury regulations also contain a rule relating to salary reduction for purposes of the 50-percent test. In aggregating plans in order to determine the level of benefit for which a nonhighly compensated employee is eligible, salary reduction relating to noncore health coverage generally is not considered available if it exceeds $2,000 unless the employee actually elects a higher amount.

Excludable employees; separate lines of business

In general, all of the employees of the employer, as well as the employees of certain related employers (e.g., subsidiary or affiliate corporations) are required to be taken into account in applying the nondiscrimination tests of section 89. There are, however, several exceptions to this rule.

Separate lines of business or operating units

If the employer has separate lines of business or maintains separate operating units, each separate line of business or operating unit may be tested separately by taking into account only those employees in that line of business or operating unit. In general, if a business location of the employer is located more than 35 miles from another location and meets certain other requirements, that location may qualify as a separate operating unit for section 89 purposes.

Under present law, headquarters employees of an employer generally may not be treated as employed in a separate line of business or operating unit. Special rules apply to determine how such employees are to be allocated to other lines of business or operating units of the employer.

Excludable employees

Certain employees are disregarded in testing for discrimination under section 89. Generally, employees in the following categories are disregarded: (1) employees who normally work less than six months per year; (2) employees who normally work less than 17.5

hours per week; (3) certain nonresident aliens; (4) employees who are under 21 years of age; and (5) employees who have less than one year of service with the employer (or six months with respect to a health plan providing core health coverage).

Some employers have raised the question of whether employees that have been determined to be uninsurable by an insurance company may be disregarded. Section 89 does not allow an employer to disregard such individuals. However, section 89 addresses the issue of uninsurable employees by permitting employers to exclude a significant number of individuals from its health plans and still meet the requirements of section 89.

There is no special definition of what individuals are "employees" for purposes of section 89. Issues arise with respect to whether certain individuals (e.g., prisoners, elected officials, and clients in sheltered workshops) are required to be treated as employees. Whether or not a particular individual is an employee is not determined by section 89 but by other provisions of the Internal Revenue Code. Thus, if an individual is considered an employee under other tax provisions (e.g., employment tax and pension plan rules), they will also be considered to be employees for purposes of section 89 unless the Secretary determines otherwise.

The Secretary, in the preamble to the Treasury regulations issued with respect to section 89, specifically requested comments on the appropriate treatment under section 89 of leased employees, prisoners, clients in sheltered workshops, and similar classes of individuals.

Part-time employees

Generally, if a part-time employee normally works at least 17.5 hours a week, then the employee is required to be taken into account when an employer tests its plans for discrimination under section 89. Section 89 contains a number of exceptions to the requirement that employees who normally work 17.5 hours or more are required to be taken into account. First, the employer may disregard any employee if the employee has coverage under another employer's health plan (e.g., a spouse's plan). In addition, section 89 contains rules that permit an employer to proportionately reduce the coverage it makes available or provides to its part-time employees in relation to the hours worked. Consequently, the employer may still meet the requirements of section 89 even if it does not provide the same level of benefits to its full- and part-time employees, for example, because part-time employees are required to pay more for the same total coverage.

Finally, TAMRA added a special rule relating to part-time employees that is available to small employers (those with fewer than 10 employees). For plan years beginning in 1989, such employers may disregard those employees who work less than 35 hours a week, and for plan years beginning in 1990, the employer may disregard those employees who work less than 25 hours a week. For subsequent plan years, the 17.5-hour rule applies.

Employees covered by a collective bargaining agreement

In general, if any employee covered under a collective bargaining agreement has health coverage, that employee and other employ-

ees in the same bargaining unit are taken into account for purposes of determining whether an employer meets the section 89 nondiscrimination rules. The effect of this rule is that, in most cases, the employer cannot disregard employees covered by collective bargaining agreements.

Family coverage

In enacting section 89, the Congress was concerned that an employer might fail the numerical nondiscrimination tests with respect to health plans covering families simply because those employees with families are disproportionately highly compensated. Therefore, several special rules apply under section 89 with respect to family coverage.

For purposes of the eligibility tests, if the employee has the opportunity to enroll in a plan providing family coverage, such coverage is treated as available to the employee without regard to whether or not the employee actually has a family.

In applying the 75-percent benefits test and the 80-percent coverage test, the employer may test its single coverage and family coverage separately. Thus, if the employee confirms to the employer that he or she does not have a family (e.g., a spouse or dependents), the employer need not consider that employee in testing its family health plans. In addition, if an employee is offered coverage (such as family coverage) at no cost to the employee and the employee declines to participate, that employee may be disregarded for purposes of testing.

Coverage from another employer

The Congress concluded in 1986 that an employer should not fail to satisfy the section 89 requirements merely because an employee declines coverage if the employee has health coverage through another employer (for example, through a spouse's employer). Therefore, employees who confirm to an employer that they have other health coverage may be disregarded in applying the nondiscrimination tests of section 89. If the employer treats employees with families separately as discussed above, then the employer may disregard an employee whose family has other coverage.

Valuation of health coverage

In order for an employer to compare differing health coverages under section 89, the employer must assign a value to each coverage. The Secretary of the Treasury is to establish tables prescribing the relative values of different types of health coverage. Under TAMRA, these tables are to be effective as of the later of (1) the first testing year beginning after the issuance of the tables, or (2) the date specified by the Secretary.

Until the issuance of valuation rules by the Secretary, an employer may use any reasonable method to value its health coverage. For example, the employer may use the cost of the coverage

determined in the same way health coverage cost is determined under the health care continuation rules (sec. 4980B).[4]

There is a special permanent valuation rule for collectively bargained plans maintained by more than one employer (called multiemployer plans). For purposes of section 89, the value of coverage provided by the employer is generally equal to the amount the employer contributes under the collective bargaining agreement on behalf of its employees. Thus, for example, if the contract requires that an employer contribute 55 cents for health coverage for each hour worked by an employee, then the value of the coverage provided to that employee is 55 cents times the number of hours worked.

Testing procedures

Under section 89, an employer chooses a testing year on which to base its testing. Within this year the employer selects a day (called the testing date) on which to determine who are its employees and what coverage is available and provided to such employees. In general, testing is based on the facts in existence on that one date. However, the testing day data is required to be adjusted to reflect changes in plan design and changes in elections by highly compensated employees that have occurred during the year. These adjustments are necessary in order to have the limited data available on the testing day reflect what actually occurred during the year.

Treasury regulations relating to section 89 contain a transition rule for 1989 testing years that permits an employer in certain cases to disregard plan design and election changes that occur prior to July 1, 1989.

Highly compensated employees

A highly compensated employee is an employee who, during the year or the preceding year (1) was a 5-percent owner of the employer, (2) received compensation in excess of $81,720, (3) was an officer of the employer and received compensation in excess of $45,000, or (4) received compensation in excess of $54,480 and was in the top-paid 20 percent of employees. The dollar limits are indexed for inflation. In lieu of calculating the top-paid 20 percent of employees, the employer may elect to treat all employees with compensation in excess of $54,480 as highly compensated employees. An employer is treated as having at least one officer even if that officer has less than $45,000 of compensation.

Former employees

Former employees are taken into account in determining whether an employer meets the requirements of section 89. However, the employer tests former employees separately from active employees. Thus, former employees are not considered when the employer tests its plans relating to active employees. Further, under

[4] In general, the health care continuation rules require that employers provide their employees (and certain other individuals) the opportunity to participate for a specified period in the employer's health plan despite the occurrence of a qualifying event that otherwise would have terminated such participation. Employers are permitted to charge the individual a specified amount for the coverage, based on the employer's cost of providing the coverage.

TAMRA, an employer is generally permitted to disregard employees who separated from service prior to January 1, 1989.

Sanctions

If an employer's plan fails to satisfy the section 89 nondiscrimination rules, then the highly compensated employees participating in the plan must include in income the value of the portion of the coverage that is discriminatory (the "discriminatory excess"). The discriminatory excess is determined based on the coverage received that is in excess of the coverage that could be provided if the plan were nondiscriminatory. The amount includible in income is based on the discriminatory excess coverage, that is, the premium paid for the coverage, not on the amount of reimbursements received under the plan. Thus, if the nondiscrimination rules are violated, a highly compensated employee is not required to include a greater amount in income merely because he or she was sick during the year.

The employer is subject to an excise tax if the employer fails to report properly on an employee's W-2 the amount includible in the employee's income due to failure to satisfy the section 89 rules. The excise tax does not apply if the failure to report the proper amount was due to reasonable cause.

B. Qualification Rules

In general

The qualification rules of section 89(k) are designed to ensure that a plan meets certain basic minimum requirements. In general, these rules require that a plan be: (1) in writing; (2) maintained for the exclusive benefit of employees; (3) legally enforceable; and (4) established with the intention that it be maintained for an indefinite period of time (the permanence requirement). In addition, an employer must give its employees reasonable notice of the benefits provided under the plan.

Plans subject to the qualification requirements

The qualification rules apply to the following types of benefit plans: (1) health plans; (2) group-term life insurance plans; (3) cafeteria plans; (4) voluntary employees' beneficiary associations (VEBAs); (5) dependent care assistance programs; (6) qualified tuition reduction programs; and (7) fringe benefit programs providing no-additional-cost services, employer-provided eating facilities, and qualified employee discounts.

Writing requirement

Treasury regulations provide that a plan will be considered to be in writing if all material terms of the plan are included or referenced in a single document. No particular format is required and several plans can be included in a single document.

Treasury regulations provide a transition rule relating to this requirement for 1989. Under the regulations, the written document requirement is not required to be satisfied by an employer until the first day of the second year that a plan is subject to section 89.

For example, if a plan has a calendar plan year, that plan need not be in writing until January 1, 1990.

Notice requirement

An employer satisfies the notice requirement by notifying those employees eligible to enroll in the plan of its existence and nature, the group of employees that may be eligible for the plan, the cost and method of enrolling in the plan, and a statement of how an employee can receive additional information about the plan. Under the Treasury regulations, the employer satisfies this requirement if this information is given to employees by the health care provider (e.g., the HMO or insurance company).

Exclusive benefit rule

In general, the exclusive benefit rule requires that the plan is to be maintained for the exclusive benefit of employees and that virtually all individuals participating in the plan are common-law employees of the employer. Self-employed individuals who are treated as employees under the rules relating to qualified retirement plans (sec. 401(c)(1)) are treated as employees for this purpose. Other individuals (i.e., nonemployees) who perform significant services for the employer may participate in the plan, as well as a de minimis number of other individuals, as long as such coverage is provided on an after-tax basis. Under a transition rule, Treasury regulations generally delay the effective date of the exclusive benefit rule for one year, to the first day of the plan year following the first plan year beginning in 1989.

Permanence requirement

Treasury regulations provide that the permanence requirement is satisfied if the plan is established and maintained for at least a consecutive 12-month period. Termination or material modification of the plan before the plan has been in effect for 12 months will not violate the permanence requirement if there is a substantial, independent business reason for the termination or modification, and the termination or modification does not discriminate in favor of highly compensated employees.

Legally enforceable requirement

A plan is considered to be legally enforceable if the conditions required for an employee to participate, receive coverage, and obtain a benefit are definitely determinable under the terms of the plan and an employee satisfying such conditions is able to compel such participation, coverage, or benefit. A plan generally is not considered to be legally enforceable if a decision as to whether to grant or deny participation, coverage, or a benefit is discretionary with the employer.

Under a transition rule, Treasury regulations generally delay the effective date of this rule for one year, to the first day of the plan year following the first plan year beginning in 1989.

Sanction

If a plan fails to satisfy the qualification requirements, then the employer pays benefits under an ad hoc reimbursement program

that attempts to convert fully taxable compensation into nontaxable benefits. Consequently, if such requirements are not met, then all employees participating in the plan are required to include in income the value of benefits (e.g., reimbursements) received under the plan. This sanction may be imposed on all employees whether or not they are highly compensated employees.

Treasury regulations contain several provisions that reduce the sanction for failure to comply with the qualification rules. First, no sanction is imposed if there is a de minimis failure to satisfy the writing or notice requirements, and the failure is corrected within 90 days after the employer has notice of the failure.

Second, the regulations limit the amount includible in income to a percentage of the individual's compensation. In particular, the amount includible for failure to meet the qualification requirements is limited to the sum of (1) 10 percent of the employee's compensation up to the dollar amount used to determine the top-paid 20 percent of highly compensated employees ($54,480 for 1989), (2) 25 percent of the employee's compensation in excess of such dollar amount but not in excess of 200 percent of such dollar amount, (3) 75 percent of the employee's compensation in excess of 200 percent such dollar amount up to and including 300 percent of such dollar amount, and (4) 100 percent of the employee's compensation in excess of 300 percent of such dollar amount. For example, if an employee has $20,000 of compensation and a taxable benefit of $30,000 by reason of a plan's failure to meet the qualification requirements (e.g., the employee had surgery for which the employer paid), the employee would not be required to include in his or her taxable income more than 10 percent of compensation ($2,000).

Third, under the regulations, if a failure to satisfy the qualification requirements is limited to a specific aspect of coverage provided in a plan, then that aspect of coverage may be treated as a separate plan for purposes of determining the amount includible in income. For example, suppose that a benefit is paid to a participant and the benefit exceeds the dollar limitation on benefits described in the written plan. The amount of the benefit in excess of the dollar limitation may, under the circumstances, be treated as a separate plan and, therefore, could be included in the taxable income of the recipient without an adverse impact on the rest of the plan or its participants.

The penalty imposed upon an employer for failure properly to report the amount includible in income on an employee's W-2 applies to failures to report income includible as a result of failure to satisfy the qualification rules of section 89.

C. Effective Date of Section 89 Rules

In general, the nondiscrimination rules and the qualification requirements of section 89 are effective for plan years beginning on or after January 1, 1989. A delayed effective date applies to plans maintained pursuant to one or more collective bargaining agreements. The effect of this delayed effective date is that in applying the nondiscrimination tests, participants in such collectively bargained plans may be disregarded until the delayed effective date at the employer's election. As described above, Treasury regulations

contain transition rules that have the effect of delaying the effective date of certain of the section 89 rules to July 1, 1989. In addition, the Treasury Department announced, on May 1, 1989, that the delay to July 1, 1989, in the regulations would be extended to October 1, 1989.

III. ISSUES

The major issues raised to date under section 89 deal with the rules as applied to employer-provided accident or health plans. Thus, the following discussion relates only to accident or health care coverage.

Complexity; recordkeeping requirements

Many employers argue that the present-law section 89 nondiscrimination rules are overly complex and impose burdensome recordkeeping requirements. For example, if an employer elects to test family coverage separately from individual coverage and to disregard individuals with other coverage, under present law, the employer is required to obtain sworn statements from its employees attesting to the employee's family status and to whether the employee (and his or her family) is covered under a plan of another employer (e.g., a spouse's plan). In addition, regardless of the employer's testing method, the employer has to determine what individuals have elected to participate in each plan of the employer. Some employers do not currently obtain and maintain such information, or do not do so in the systematic manner required to demonstrate compliance with section 89.

Some employers, particularly small employers, argue that the alternatives available in applying the nondiscrimination rules only serve to make the rules more complex.

On the other hand, much of the complexity of the present-law rules is the direct result of the desire of the Congress to allow employers greater flexibility in designing their benefit plans. Because the benefit plans of employers differ greatly in design, various options and elections that employers may use to demonstrate compliance with section 89 are arguably necessary to account for such design differences. Many of the present-law rules, e.g., the rules permitting the separate testing of family coverage and the provisions added in the TAMRA, were the direct result of input from employers and health-care providers who argued that such rules eased the burdens of section 89.

Also, some of the rules adding to the perceived complexity of section 89 are elective on the part of an employer. For example, an employer is not required to test its plans under all possible methods, but may test under any one of the available methods. Thus, the employer may choose to limit the amount of testing to which it is subject under present law.

Some employers have also argued that the lack of a permanent rule for valuing health benefits makes the rules more difficult to apply. Thus, some employers have argued that the temporary valuation rule added by TAMRA should be made the permanent valuation rule.

Possible employer responses to nondiscrimination requirements

Some have argued that the overall effect of the section 89 nondiscrimination rules will be to decrease health insurance coverage of individuals, rather than to promote the expansion of such coverage to those employees who need the coverage the most. Under this theory, for some employers, the costs of compliance with section 89 outweigh the benefits of maintaining employer-provided accident and health plans and, therefore, it is most economical for such employers to eliminate the coverage rather than to comply with the nondiscrimination requirements.

This argument is countered by those who point out that an employer's decision whether or not to maintain a health plan is often driven by the demands of the labor market from which the employer draws. This effect of the labor market is particularly apparent in the case of medium- and large-sized employers who must pay competitive wages and benefits in order to maintain an adequate workforce.

Further, some point out that the response of an employer to nondiscrimination requirements is likely to depend upon the degree to which the employer's plans fail to satisfy the requirements. If the failure to satisfy the nondiscrimination requirements occurs because of the failure to provide an accident and health plan to a relatively small number of employees, an employer may be willing to extend coverage to those employees, thereby satisfying the policy goal of expanded coverage.

On the other hand, if an employer's failure to satisfy the nondiscrimination requirements occurs because of a particularly generous plan provided primarily to its highly compensated employees, the employer may not be willing to eliminate the coverage to satisfy the section 89 rules. In such a case, the employer will include the value of the discriminatory coverage as taxable income on the W-2s of its highly compensated employees and may decide to increase such employees' salaries by the additional tax the employees will pay on the discriminatory benefits. The policy objectives of the nondiscrimination rules are also being satisfied in such a case because the Federal Government is no longer subsidizing health benefits that are disproportionately provided to highly compensated employees.

In the case of small employers, some argue that the demands of the labor market will not be as significant because such employers often draw workers who are not highly skilled or organized. Further, the costs of compliance may be larger as a percentage of total costs of wages and benefits than they would be for larger employers. In such cases, an employer may view the cost of complying with the nondiscrimination requirements as a significant deterrent to the continued maintenance of a health plan.

On the other hand, some argue that, even for small employers, there are advantages to maintaining a health plan at least on an after-tax basis for the benefit of group insurance rates, employee morale, and recruitment and retention of skilled highly compensated employees.

Part-time employees

Many employers argue that the present-law definition of part-time employee (employees who normally work more than 17.5 hours per week) is unduly restrictive, and does not conform to normal business practices in certain industries. They argue that it is unrealistic to expect employers to expand coverage to employees whose health benefits constitute a significant percentage of their overall wages. Moreover, some employers contend that it is currently difficult to obtain insurance for part-time employees.

Because of these problems, some employers have argued that the 17.5-hour standard should be increased, or that the requirement that part-time employees be taken into account should be phased-in over time.

Others argue that part-time employees should be taken into account under the nondiscrimination tests because such employees constitute a significant portion of the individuals without any available health care coverage. They point out that section 89 does not require that an employer provide coverage to part-time employees. Rather, if such an employee does not have coverage (from the employer or another employer, such as under the plan of a spouse), the fact that the employee cannot be ignored reduces the likelihood that the employer can pass the nondiscrimination tests. This result is consistent with one of the general purposes of section 89, which is to reduce the tax subsidy of employer-provided health coverage if an employer has a significant number of nonhighly compensated employees without health coverage (whether from the employer or from another employer).

Further, some argue that one reason that the nondiscrimination requirements do not require an employer to make health plans available to all of its employees is to permit the employer flexibility in determining the classes of employees who are excluded from eligibility for the employer's health plans beyond those classes of employees that are automatically excluded from consideration. Under this argument, the nondiscrimination requirements already take into account the problems employers face with respect to providing health benefits to rank-and-file employees by allowing the employer to offer coverage to less than 100 percent of its workforce and still satisfy the nondiscrimination requirements.

Employees covered by collective bargaining agreements

Under present law, most employers are required to take employees covered by collective bargaining agreements into account in applying the nondiscrimination tests. This requirement can help an employer pass the nondiscrimination tests if the union has bargained for benefits that are generous relative to the benefits provided to the employer's other nonhighly compensated employees. On the other hand, this requirement can make it more difficult for an employer to pass the tests if a significant portion of the employer's employees are covered under a collective bargaining agreement that provides less generous benefits than those generally provided to the employer's other employees.

Some have argued that the collective bargaining process should not affect the employer's other employees and that the benefits

provided outside the bargaining agreement should not affect the employees covered by the agreement. For example, under present law, a highly compensated union employee may be required to include the value of health coverage in income because the employer provides lower benefits to its rank-and-file nonunion employees, even though all union employees receive the same benefits. Some people believe that present law may give a union inappropriate leverage in the negotiation of a collective bargaining agreement if the employer cannot satisfy the nondiscrimination requirements because of the benefits provided to collectively bargained employees. Thus, some people argue that plans maintained pursuant to a collective bargaining agreement should be tested separately from other plans of the employer. Such a rule would be more consistent with the treatment of union employees under the rules applicable to qualified pension plans.

Others argue for the present-law rule relating to the treatment of collectively bargained employees. Some employers prefer the present-law rule because it aids them in meeting the requirements of section 89. Some argue that the leverage the present-law rule may give the union is appropriate. Requiring union employees to be taken into account may serve to increase the level of coverage of such employees, which is consistent with the general purposes of section 89.

The present-law rule may reduce the level of discrimination in some cases. For example, if an employer's nonunion employees are all highly compensated, then present law would generally prevent the employer from providing a disproportionately high level of benefits to the highly compensated employees. If the union employees are tested separately, however, then there is no limit on the tax-favored benefits that can be provided to the highly compensated employees.

Some also argue that benefits provided pursuant to collective bargaining agreements should not be subject to the nondiscrimination rules. Proponents of this view argue that the operation of the collective bargaining process is sufficient to deal with the policy purposes of section 89 and that the nondiscrimination rules should not be allowed to influence the collective bargaining process. They argue that an exemption is particularly appropriate in the case of multiemployer plans (i.e., plans maintained by more than one employer). Under this view, recordkeeping presents particular problems in the case of such plans, because the employer may not know what the benefits are under the plan, or whether an employee is eligible to participate in the plan. However, many of the recordkeeping problems under present law were addressed in TAMRA.

Opponents of an exemption argue that there is no policy justification for exempting collectively bargained plans from nondiscrimination rules. At the very least, tax benefits should be limited if the benefits under the agreement discriminate in favor of high-paid collectively bargained employees if the collectively bargained plan is tested separately.

Leased employees

Under present law, in applying the nondiscrimination tests, an employer is required to take into account certain individuals who

perform services for the employer, other than the common-law employees of the employer. These individuals, called leased employees, are generally defined as individuals who perform services for the employer of the type normally performed by an employee on a substantially full-time basis, even though the individual is nominally employed by another employer. Leased employees must be taken into account by an employer for purposes of the nondiscrimination rules applicable to qualified retirement plans as well as the section 89 rules.

The leased employee rules are designed to prevent circumvention of the nondiscrimination rules. For example, suppose a doctor maintains a health plan for himself, but does not cover his nurses or his office administrative staff (e.g., a secretary). Instead of directly employing his nurses and administrative staff, he leases them from a leasing organization. Without the leasing rules, the doctor would be able to exclude his nurses and staff from the doctor's benefit plans, and provide generous benefits to himself, even though the nurses and staff work only for him and work on a substantially full-time basis.

Many employers argue that taking their leased employees into account under section 89 creates significant administrative problems. Their main concern is that it is difficult to identify leased employees because the statute and proposed Treasury regulations contain a broad definition of who constitutes a leased employee. They argue that leased employees should be ignored in applying the nondiscrimination rules.

Others argue that disregarding leased employees would permit employers to avoid the nondiscrimination rules. Moreover, many leased employees have no health coverage. Thus, disregarding leased employees could undermine one of the policy objectives of section 89.

Some alternative modifications to section 89 have been suggested that would deal with employer concerns without undermining section 89's policy objectives, including (1) delaying the effective date of the section 89 rules to leased employees to give the Treasury Department time to develop alternative rules for leased employees, (2) modifying the definition of a leased employee, and (3) providing that leased employees do not have to be taken into account if they are covered by a safe harbor health plan of the leasing organization. The last alternative is similar to the approach under the rules applicable to qualified retirement plans.

Former employees

Some employers do not have the information necessary to apply the nondiscrimination rules to employees who have already separated from service, and thus argue for a delay in applying the nondiscrimination rules to former employees.

Opponents of delay of the rules to former employees argue that recordkeeping requirements for former employees were adequately addressed in TAMRA. Under TAMRA, employees who separated from service prior to January 1, 1989, can generally be ignored for purposes of the nondiscrimination rules. However, employees who separated from service prior to January 1, 1989, may not be disregarded if their benefits are changed; this restriction may reduce

significantly the former employees who may be disregarded because benefit changes are not uncommon.

In addition, some employers argue that it is difficult to maintain records for any former employees and that section 89 will require them to maintain records for all terminated employees. Thus, they argue that the nondiscrimination rules of section 89 should not be applied to former employees.

Those opposed to this view argue that it is appropriate to apply nondiscrimination rules to former employees for the same reasons that nondiscrimination rules are applied to benefits of active employees. For example, without nondiscrimination rules, an employer could provide retiree health benefits only to its retired key executives. Moreover, it is argued that present law permits an employer to impose reasonable age and service requirements on the receipt of benefits by former employees (e.g., attainment of age 55 with 10 years of service). Thus, the employer will not be required to track all of its former employees in order to apply the tests.

Salary reduction arrangements

Many employers maintain plans that permit an employee the choice between receiving cash or purchasing nontaxable benefits, such as health coverage. These plans are generally referred to as cafeteria plans or salary reduction arrangements, and the contributions made by employees to purchase benefits are generally called salary reduction contributions. Salary reduction contributions generally are not included in the taxable income of the employee.

Many employers have adopted cafeteria plans in order to take advantage of the flexibility and tax benefits such arrangements provide to employees. For example, some employers permit employees to pay the mandatory employee premium for health coverage on a salary reduction basis.

A medical reimbursement account (or flexible spending arrangement) is a type of salary reduction arrangement. Under a flexible spending arrangement, the employee can elect the amount contributed to the account, and then use such amounts to purchase health coverage for benefits not otherwise covered by insurance (e.g., to pay deductibles under the health insurance plan or to pay for items that might not be covered by insurance, such as orthodontia expenses). These expenses, if reimbursed through coverage under a flexible spending arrangement, are not included in the taxable income of the employee, notwithstanding the fact that identical expenses paid with after-tax dollars may not have the same tax-favored treatment because medical expenses of individuals are not deductible unless they exceed 7.5 percent of the individual's adjusted gross income.

Some employers and employees like the flexibility of a cafeteria plan because it lets each employee tailor the nontaxable benefits the employee receives to his or her own needs. Further, some employers consider salary reduction arrangements an essential method by which they can shift a portion of the ever increasing cost of health coverage to the employee. These employers argue that they could no longer afford to provide health coverage to their employees without the cost savings they realize through these salary reduction arrangements. Implicit in this argument is the as-

sumption that the employees are willing to bear a cost of benefits on a pre-tax basis that they are unwilling to bear on an after-tax basis.

On the other hand, some argue that, although salary reduction arrangements permit cost shifting, they do not contribute to overall health cost containment. Such arrangements and, in particular, flexible spending arrangements may serve to increase health costs by subsidizing overutilization of health care services, particularly if they permit employees to pay for first-dollar coverage (e.g., coverage below the deductible limit in the insurance policy) on a tax-preferred basis.

In applying nondiscrimination rules to salary reduction contributions, the key issue is whether such amounts should be considered as employee or as employer contributions to an employee benefit plan.

Some argue that the primary impact of salary reduction contributions on an employee depends on whether one is evaluating the affordability of health care for purposes of an eligibility test or is calculating the value of tax-favored benefits an employee actually receives for purposes of a benefits test. Proponents of this view argue that salary reduction contributions affect whether a rank-and-file employee can afford to participate in a plan. They argue that, aside from certain administrative costs, there is little or no cost to the employer in making salary reduction available to employees. In addition, such contributions reduce the cash available to the employee just as employee after-tax contributions do. Moreover, any eligibility rule that looks to whether coverage is meaningfully available to rank-and-file employees could be easily avoided if salary reduction is not taken into account as an employee contribution. Therefore, these individuals argue that salary reduction is properly considered an employee cost for rank-and-file employees for purposes of an eligibility test.

Proponents of this view also argue that it is the highly compensated who can afford to reduce their salaries and take advantage of the tax benefits of a salary reduction arrangement. Further, salary reduction represents significant tax-savings for highly compensated employees. Failure to treat salary reduction as an employer contribution for purposes of a benefits test could lead to abuse of any nondiscrimination rule, because an employer could simply provide all health coverage to highly compensated employees through salary reduction at no additional cost to the employer or the employee.

As an illustration of this point, assume that an employer pays a highly compensated employee a salary of $5,000 a month and a health benefit worth $300 a month, $200 of which exceeds the health benefit that could be provided on a nondiscriminatory basis. The employee's overall monthly compensation is $5,300, $5,200 of which would be taxable under the nondiscrimination test. If salary reduction is not treated as an employer-provided benefit, the employer could make $200 of salary reduction available to the employee, and reduce the employer-provided health benefit from $300 to $100. Thus, the employee would have $5,200 of salary, but $200 would not be taxable because the employee would elect $200 of salary reduction to pay for his health benefit. The employee's over-

all compensation would still be $5,300, $5,000 of which would be taxable, the employer's total compensation costs would be unchanged, and the nondiscrimination requirements would be satisfied. Thus, the nondiscrimination rules would have no effect if salary reduction contributions are not treated as employer-provided benefits.

There are several alternative methods that might be used to deal with the issues relating to the treatment of salary reduction under any health coverage nondiscrimination rule. One approach would be to treat salary reduction amounts as attributable solely to employee contributions or employer contributions. However, as discussed above, such a rule could effectively undermine any nondiscrimination rule.

Alternatively, an approach similar to the approach under present law could be used. (See the discussion of present law above.) This would allow the treatment to vary depending upon the amount of salary reduction available to an individual and the terms under which it is made available. A similar approach might treat all or a portion of salary reduction available to the rank-and-file employees as employer-provided when calculating the amount actually received by the high paid. On the other hand, such an approach might be said to defeat the principle of making available affordable health care coverage.

Another approach would be to recognize as employer-provided the tax savings to the employee achieved through the use of salary reduction. This approach could apply with respect to whether coverage is available to, or received by, an employee. For example, each dollar of salary reduction available to a nonhighly compensated employee could be considered 15-percent employer-provided and 85 percent employee-provided (assuming a 15-percent tax rate with respect to such employee).

Alternatively, salary reduction could be treated solely or partly as employee contributions for purposes of section 89 and the rules relating to cafeteria plans under section 125 of the Code could be tightened in order to ameliorate discrimination concerns under cafeteria plans.

State and local governmental plans

Some argue that the nondiscrimination rules of section 89 present special problems for State and local government employers. For example, such employers generally have large numbers of employees and may not have centralized recordkeeping, making data collection more burdensome. In addition, in some cases it is difficult to identify who the employer is (e.g., the State government or a local government) and thus difficult to determine the proper employee group on which to apply the tests.

Because of these issues, some argue for special rules for State and local governmental plans. Some also argue that such plans should be exempted from the rules. They argue that, because benefits under such plans are often determined pursuant to collective bargaining or State or local law, the benefits are already subject to sufficient scrutiny to ensure that they are nondiscriminatory.

Opponents of an exemption for State and local government plans argue that there is no policy justification for exempting such plans.

Benefits provided under such plans represent a tax expenditure in the same way that benefits provided under plans of private employers do, i.e., the benefits are excludable from income. Thus, nondiscrimination rules should apply to such plans for the same reason these rules should apply to plans of private employers—to limit the tax expenditure unless the benefits are provided on a nondiscriminatory basis. Moreover, it may be more difficult to justify application of the rules to plans maintained by private employers if governmental plans are exempted.

Such individuals argue that, to the extent public employers have specific concerns with the nondiscrimination requirements, such concerns should be directly addressed. For example, if collectively bargained plans are an issue, then any modification of the treatment of such plans in general should also apply to collectively bargained plans maintained by State and local governments.

Qualification rules

The main issue that has been raised with respect to the qualification rules is the sanction for failure to satisfy the rules. Under present law, if a plan fails the qualification rules, then all employees are taxed on the benefits received (e.g., reimbursements for health care) under the plan. This sanction has received considerable attention because of the possibility that a rank-and-file employee could have a large income inclusion if the employee is sick during the year and is covered by a plan that fails the qualification rules. The sanction has been criticized as unfair because it may penalize employees who have no control over, or responsibility for, the failure of the employer to satisfy the rules.

Several alternatives to the present-law sanction have been suggested, including (1) applying the sanction only to highly compensated employees, (2) limiting the amount the of income inclusion (e.g., to a percentage of compensation), (3) limiting the inclusion to the value of coverage in the case of benefits provided through a third-party insurer, and (4) applying the sanction to the employer rather than the employees. An employer sanction could take the form of an excise tax, or the denial of the deduction for the benefits. An excise tax has the advantage that it applies to all employers, not only those that pay income tax.

Some employers have argued that the standards for determining whether a benefit is legally enforceable is not well defined and that, accordingly, it is difficult for an employer to determine whether this qualification requirement is satisfied.

Others counter that the Treasury regulations provided guidance with respect to the standard of legal enforceability that should address the concerns of the majority of employers.

An additional argument relating to the qualification standards that is made by employers is that the exclusive benefit rule is difficult to administer in the case of health plans and is arguably less needed in the area of health benefits than it is with respect to the pension benefits. They also argue that the rule may prohibit the inclusion of individuals who are not employees in an employer's health plan for no legitimate policy reason.

On the other hand, some argue that the justification for the exclusive benefit rule is the same in the case of health benefits as it is for pension benefits.

Repeal or delay of section 89

Some have argued that section 89 should be repealed or delayed in order to give employers more time to adjust to the rules, and the Congress more time to modify the rules. Opponents of repeal or delay argue that the nondiscrimination rules serve to fulfill important policy objectives, and that such objectives should not be abandoned. They argue that it is more appropriate to modify the rules to make them less complex without compromising the basic policy objectives. In addition, repeal or delay would have revenue implications that the Congress would be required to address.

Other issues

Some employer groups have suggested alternatives to the present-law rules other than repeal or delay. Some employers have advocated a design-based nondiscrimination test. A design-based test is one that an employer can satisfy by designing its benefit program in a certain way. Passage of a design-based test is not dependent on individual employee elections as to coverage so that such a test reduces required recordkeeping.

Some employers have also argued that they should be able to avoid testing simply by including the value of coverage in the income of highly compensated employees. It is not clear under present law whether such an approach is permissible.

Some employers have already incurred significant expense to modify their benefit plans to comply with present law. They argue that they should not be disadvantaged by any changes to section 89.

IV. DESCRIPTION OF CERTAIN BILLS RELATING TO SECTION 89

A. S. 654—Senator Pryor

S. 654, the Section 89 Simplification Act, introduced by Senator Pryor and others on March 17, 1989, modifies several present-law rules contained in section 89 and, in addition, creates a safe harbor from the otherwise applicable nondiscrimination rules of section 89 in the case of a health plan that qualifies as a simplified health arrangement.

Nondiscrimination safe harbor

The bill provides that an employer's health program for its employees is considered nondiscriminatory and the employer is not required to test its plan under section 89 if the plan is a simplified health arrangement. A plan is a simplified health arrangement if: (1) at least 90 percent of the employer's employees are eligible to participate in the plan or a plan of the same type having the same employer-provided benefit; and (2) the cost to an employee of a plan is no more than the applicable premium. The applicable premium is $6.70 per week ($348.40 per year) for employee-only coverage, and an additional $6.70 per week for family coverage (i.e., coverage of the employee's family). The applicable premium (i.e., $6.70) is indexed to the cost-of-living adjustments for income tax brackets. However, the applicable premium shall not be less than 5 percent of the minimum wage multiplied by 40 (i.e., 5 percent of the minimum wage calculated on the basis of a 40-hour work week). The qualification requirements of section 89 continue to apply to simplified health arrangements.

Modifications of present-law nondiscrimination rules

Definition of part-time employee

The bill permits an employer to disregard employees normally working less than 30 hours a week in 1989, 27.5 hours a week in 1990, and 25 hours a week thereafter (compared to 17.5 hours per week under present law).

Definition of highly compensated employee

The bill amends the definition of who constitutes a highly compensated employee for purposes of section 89. Under the bill, officers with compensation not in excess of $45,000 would not be considered highly compensated employees.

Family coverage

Under present law, an employer may test family health coverage (i.e., coverage of the employee's spouse and dependents) separately

from employee-only coverage for purposes of the 75-percent benefits test and the 80-percent alternative coverage test. When separately testing family coverage, an employer may disregard those employees who do not have families. An employer generally may not disregard an employee from family testing on the ground that the employee has no family unless the employer obtains a sworn statement confirming the family status of that employee. Under the bill, an employer's plan is deemed to satisfy the 75-percent benefits test or the 80-percent alternative coverage test with respect to family coverage if: (1) the employee-only portion of the coverage meets the 75-percent benefits test or the 80-percent alternative coverage test; (2) the family coverage is available on the same basis to both highly and nonhighly compensated employees; and (3) the employee has family coverage available at no more than the applicable premium for a simplified health arrangement (i.e., a maximum premium of $6.70 per week).

Employee cost comparability

Under present law, for purposes of the 80-percent alternative coverage test, two or more plans are generally considered comparable if an employee is eligible to participate in all the plans and the annual difference in cost to an employee among such plans is not greater than $100. This $100 amount is to be increased relative to adjustments in the cost of living. Under the bill, this $100 limit is increased to $365 indexed in the same manner as under present law.

Valuation of health coverage

Under present law, until at least one year after the Secretary issues valuation tables relating to health coverage, an employer may use any reasonable method to value its health plans for purposes of applying the nondiscrimination tests. Under this transition rule, the cost method the employer uses for purposes of determining the applicable premium under the health care continuation rules is generally considered reasonable. The bill makes this transition rule permanent.

Testing date

Under present law, an employer chooses a testing day on which to base its testing under the nondiscrimination requirements for the year. However, data collected on the testing day is required to be adjusted to reflect changes in plan design and changes in elections by highly compensated employees that have occurred during the year. The bill eliminates the requirement that the testing day data be adjusted for changes in elections by highly compensated employees.

Failure to comply with qualification requirements

Under present law, an employer's fringe benefit plans are required to meet certain minimum standards, for example, that the plan be in writing, that employees be notified of plan provisions, and that the plan be maintained for the exclusive benefit of employees. If an employer's plan does not satisfy these requirements, then all employees must include in income the value of benefits

(e.g., reimbursements for health care) received under the plan. The bill modifies the sanction for failure to meet the qualification requirements so that only highly compensated employees are required to include in income the value of the coverage (i.e., the employer-paid premium) relating to the failed plan.

Effective date

The provisions of the bill are effective as if included in the Tax Reform Act of 1986. Thus, the bill is generally effective for plan years beginning after December 31, 1988.

B. S. 595—Senator Domenici

S. 595, introduced by Senator Domenici and others on March 15, 1989, delays the application of section 89 until plan years beginning after December 31, 1990. In addition, the bill makes section 89 inapplicable to any employer who employs less than 20 employees on each day of the year (determined without regard to those employees who are disregarded in applying the nondiscrimination tests).

Under the bill, the definition of part-time employee is amended so that an employer can disregard employees normally working less than 25 hours per week.

The bill creates an eligibility safe harbor that allows an employer to satisfy section 89 if all its nonhighly compensated employees are eligible to participate in a plan as valuable as the most valuable plan available to any highly compensated employee. The value of a plan is determined with respect to the portion of the plan that is paid by the employer. The nondiscriminatory provision test contained in present law continues to apply.

The bill changes the 80-percent alternative coverage test to a 65-percent coverage test.

The provisions of the bill are effective as if included in the Tax Reform Act of 1986. Thus, the provisions are generally effective for plan years beginning after December 31, 1988.

C. S. 89—Senator Symms

S. 89, introduced by Senator Symms and others on January 25, 1989, delays the effective date of section 89 for one year, so that it is effective for plan years beginning after December 31, 1989.

D. S. 350—Senator Lott

S. 350 introduced by Senator Lott and others on February 7, 1989, repeals section 89, effective as if section 89 was not enacted in the Tax Reform Act of 1986.

E. H.R. 1864—Mr. Rostenkowski

H.R. 1864, introduced by Mr. Rostenkowski and others on April 13, 1989, makes substantial revisions to section 89. The bill is intended to reduce significantly the recordkeeping and data collection requirements of section 89 while retaining the policy objectives of the nondiscrimination rules.

Nondiscrimination test

The bill replaces the current section 89 nondiscrimination rules for health plans with a single simplified test. In general, an employer's health plan passes the bill's test if the plan contains no provision that discriminates in favor of highly compensated employees and the plan satisfies the following requirements:

(1) at least one plan or a group of plans providing primarily core health coverage is available to at least 90 percent of the employer's nonhighly compensated employees at an employee cost of no more than $10.00 per week (i.e., $520 per year) in the case of individual coverage, or $25.00 per week (i.e., $1,300 per year) in the case of family coverage (i.e., coverage of the employee and the employee's family); and

(2) the maximum amount of employer-provided coverage that may be excluded from the income of any highly compensated employee is not more than 133 percent of the employer-provided coverage made available to 90 percent of the nonhighly compensated employees.

The first part of the test is referred to as the eligibility test, and the second part is referred to as the benefits test.

Eligibility test

If the employer fails to satisfy the eligibility test, then the value of all health coverage provided to highly compensated employees is includible in the taxable income of the highly compensated employees. For purposes of the limit on mandatory employee contributions (i.e., employee cost) under the eligibility test, amounts paid through salary reduction are treated as an employee contribution. The dollar limits on mandatory employee contributions are indexed for changes in average wage growth.

As under present law, the bill provides that the employer-provided coverage under a plan may be excluded from the taxable income of a highly compensated employee only if the plan does not contain any provision that (by its terms, operation, or otherwise) discriminates in favor of highly compensated employees. The purpose of the nondiscriminatory provision requirement is to preclude executive-only plans and other inherently discriminatory practices.

Benefits test

Under the benefits test, the maximum coverage that a highly compensated employee may exclude from income generally is 133 percent of the value of the employer-provided employee-only coverage that is taken into account in satisfying the 90-percent test. However, if a highly compensated employee elects family core coverage, and if the employer maintains a plan that provides family coverage that meets the requirements under the bill for the 90-percent test, then the maximum tax-favored coverage is increased. The maximum coverage for such an employee is 133 percent of the value of the employer-provided benefit relating to family coverage that would otherwise satisfy the 90-percent test if family coverage were separately tested.

Any employer-provided coverage received by a highly compensated employee in excess of the level of employer-provided coverage

that meets the benefits test is includible in the taxable income of such employee.

For purposes of determining the value of the employer-provided benefit received by highly compensated employees under the benefits test, the bill treats salary reduction as employer contributions.

In determining the value of the employer-provided benefit under a plan for purposes of the benefits test, the bill retains present law, including the rules enacted as part of TAMRA. Thus, for example, as under present law, an employer may use premium cost as determined under the health care continuation rules, or can use any reasonable valuation method in lieu of employer premiums until after the issuance of valuation rules by the Secretary. In addition, the special rule for valuation of benefits under multiemployer plans applies.

Election not to test

Under the bill, an employer may elect to forego testing under the nondiscrimination requirements and instead may include the employer-provided benefit for health coverage as taxable income on the W-2 of highly compensated employees.

Part-time employees

Under the bill, employees who normally work less than 25 hours a week are disregarded for purposes of the nondiscrimination tests (compared with 17.5 hours under present law). Mandatory employee premiums may be proportionately increased with respect to those employees that normally work less than 30 hours per week. In such a case, for purposes of the benefits test, the part-time employee is considered as eligible for the same employer-provided coverage as a full-time employee (even though the value of the employer-provided coverage is reduced because the employee pays more for the coverage).

Leased employees

Under the bill, an employer may disregard a leased employee if the leasing company certifies to the employer that such employee has available a core health plan meeting the limitations on mandatory employee contributions contained in the eligibility test. This rule, like the rule in the pension plan area, is only available if leased employees do not constitute more than 20 percent of the employer's nonhighly compensated workforce.

Employees covered by a collective bargaining agreement

The bill provides that plans maintained pursuant to collective bargaining agreements are tested separately. The rule is to be applied on a bargaining unit by bargaining unit basis.

Former employees

As under present law, the nondiscrimination tests are applied separately to former employees of the employer. The bill delays the application of section 89 to former employees for one year, to 1990. In addition, generally no employee who separates from service prior to January 1, 1990, is to be considered in determining wheth-

er the employer meets section 89 with respect to its former employees.

Definition of highly compensated employee

The bill amends the definition of who constitutes a highly compensated employee for purposes of section 89. Under the bill, officers with compensation not in excess of $45,000 will not be considered highly compensated employees.

Plans other than health plans

The bill generally provides that the nondiscrimination rules in effect prior to the Tax Reform Act of 1986 apply to group-term life insurance. The nondiscrimination rules contained in section 129 as amended by the Tax Reform Act of 1986 apply to dependent care assistance programs.

Failure to comply with qualification rules—excise tax on employer

The bill replaces the present-law sanction for failures to satisfy the plan qualification requirements of section 89 with an excise tax on the employer. The excise tax is equal to 34 percent of the cost to the employer relating to the coverage that failed the qualification requirements. Generally, the cost to the employer is calculated as under the health care continuation rules relating to all coverage under the failed plan.

Effective date

The bill is effective for plan years beginning after December 31, 1989. However, the employer may use either present law or the new rules for 1989. The rule relating to the sanction under the qualification rules and the rule allowing an employer to forego testing are effective for plan years beginning after December 31, 1988.

F. H.R. 634—Mr. LaFalce

H.R. 634, introduced by Mr. LaFalce and others on January 24, 1989, repeals section 89, effective as if section 89 had not been enacted in the Tax Reform Act of 1986.

○

PREPARED STATEMENT OF WILLIAM J. BURCKLEY

Mr. Chairman, my name is William Burckley, and I am a City Councilman from the City of Greensboro, North Carolina. I am also a Certified Public Accountant. I am here today on behalf of the 16,000 cities and towns represented by the National League of Cities and the 11,000 state and local finance officials of the Government Finance Officers Association. We are pleased to have this opportunity to testify before the Committee today on an issue that is having a direct and costly impact upon the nation's cities, counties and states. We appreciate your concern over the disruption caused by the implementation of Section 89 and hope the Congress will act soon on this complicated and costly administrative burden for state and local governments.

We agree with the motivations of Section 89: that taxpayers' dollars must be spent in a fair and equitable manner to achieve the public policy goal of affordable health care for employees. State and local officials apply these rules every day in the running of the nation's municipalities. The expenditure of approximately $40 billion a year to encourage employers to provide adequate health care benefits to workers is a major federal commitment and public examination of the expenditure of these dollars is understandable. Public examination already occurs in state and local governments with scrutiny through the legislative process and by taxpayers. The federal review required by Section 89 is an additional and costly administrative burden.

However, public officials have found that the burdens of the law far outweigh the benefits for public sector employees. Typically, state and local governments offer the same benefit package to all employees. In fact, a recent Bureau of Labor Statistics publication, "Employee Benefits in State and Local Government, 1987," reports that 94 percent of full-time state and local workers participate in an employer-sponsored health care plan. So not only are benefits equitable between highly compensated and non-highly compensated workers but participation in the plans is extremely high. My City has 2208 permanent employees and 100% are covered under a City sponsored plan.

It has been estimated by the Society of Professional Benefit Administrators that compliance costs will be at least $50.00 per employee. On a national basis this would mean $700 million annually to test the benefits of our collective 14 million state and local government employees. This federal mandate comes at a time when the nation's cities, counties and states are trying to fight drug abuse, provide affordable housing and repair crumbling infrastructure. Having to spend the limited resources we have on an administrative exercise only to prove that we are not discriminating in the provision of employee benefits is an unnecessary fiscal strain.

I want to cite to you the experience of Greensboro as it relates to my city's effort to comply with Section 89 and the related regulations. We estimate it will cost the citizens of Greensboro as least $34,000 to prepare to comply with Section 89 in the first year and a minimum of $12,000 per year and every year thereafter.

Our city staff had to modify our existing payroll computer program to be able to track part-time employees. Cost: $1,500

City staff time was spent gathering data for our outside benefit consultant who did an initial analysis of all city benefits to see if any highly compensated employees received excess benefits under Section 89. Cost: $1,500

Our city hired an outside consultant to do a preliminary Section 89 discrimination study. Cost: $3,000

The city will have to review, and in all likelihood, reprint all our publications dealing with employee benefit programs in order to meet all of the requirements of Section 89. Cost: $8,500.

The city will have to distribute new booklets to all employees. Each employee will be required to sign a statement verifying receipt of these booklets. Each signed statement will have to be placed in the employee personnel file. The distribution and verification process will be time consuming and therefore very expensive. Cost: $19,500.

The City of Greensboro offers the same selection of benefits to all of our employees from our city manager down to our lowest paid hourly worker. Currently, employees may choose from twelve health plans. they may select the plan that best fits their personal needs. These plans are intended to give our employees a maximum amount of flexibility in choosing benefits.

Benefits provided by state and local government employees undergo a process of public review, be it by the state legislature, the local council or at the bargaining

table. Because this scrutiny allows little room for discrimination an exemption should be extended to the public sector.

SIMPLIFICATION EFFORTS

Efforts to simplify the existing law would provide considerable relief to state and local governments. We applaud the introduction of S. 654 and H.R. 1864. Small governments in particular will be helped by the change in the definition of highly compensated as it relates to officers. Approximately half of the 87,000 state and local governmental units will benefit from the modification in the definition of highly compensated to exclude the requirement that the "highest paid" must be considered highly compensated regardless of salary level. Some of the smallest towns have employees eligible for the earned income tax credit who would qualify as highly compensated for the purposes of Section 89 testing. We would encourage the Chairman and the Secretary of the Treasury to clarify in a public statement that entities that meet this revised definition will not have to undertake Section 89 testing. Our concern is that many small governments will hire consultants and expend funds over the next few months, before any legislation is passed, to comply with the law.

We also support a change in the definition of a part-time employee to 25 hours from the 17½ hours contained in current law. We would ask for a clarification under the bill's definition of employee to exempt prisoners from testing. Also, dropping the testing of employer-provided life insurance under Section 89 and relying on existing rules will simplify compliance.

Areas of special concern for state and local government are:

- *Contribution Limits*

We are concerned over the employee contribution levels that are set out by these bills. In reviewing the level of employee contributions in state plans we have found that at least 27 states would exceed either or both the single or family contribution rates according to the "1988 Survey of State Employee Health Benefits Plan" by Martin E. Segal Company (See Appendix A). The states are Arizona, Arkansas, California, Colorado, Florida, Idaho, Illinois, Kansas, Kentucky, Louisiana, Minnesota, Missouri, Montana, Nevada, New Jersey, New Mexico, North Carolina, North Dakota, Oklahoma, Oregon, South Dakota, Tennessee, Texas, Utah, Virginia, Wisconsin, and Wyoming.

States and localities will be more affected by this rule because our employees contribute more often and at higher rates than their private sector counterparts. Therefore, we would urge that the dollar limits be dropped for local governments and that compliance turn on the availability of the plan. We would recommend that contributions be based on a percentage of cost to allow for regional differences and be indexed to medical cost increases.

- *Collectively Bargained Plans*

Benefits of union employees are set through the collective bargaining process. Neither the employer or the employee has total control over benefit levels but both have an opportunity to influence the outcome. Because of this mutual input into establishing benefits, we believe that collectively bargained benefits should be exempted from Section 89 testing.

To provide for flexibility in testing of collectively bargained plans, employers should have an option to test them as separate units or in aggregations with other plans.

- *Definition of Employer*

In the state and local government sector the definition of employer may not be as clear as in the private sector. Often operational responsibility and plan responsibility is not held by the same entity. For testing purposes the employer should be the entity which has budgetary authority over the administration of the benefits. For example, school district employees should be tested separately from the general workers of the city. Where there is a state-wide administered plan the central administrator of the plan should be responsible for testing.

- *Excise Tax on State and Local Governments*

While the imposition of penalties for deliberate violations by employers are appropriate, we are concerned with any proposal to impose a federal excise tax on another level of government.

- *Cafeteria Plans*

The different treatment of salary reductions of highly and non-highly compensated employees will severely curtail the operation or creation of cafeteria plans.

Salary reductions for highly compensated are treated as employer contributions and as employee contributions for non-highly compensated creating a bias that in most cases will cause these plans to fail the benefits test and become taxable to the highly compensated. Salary reduction arrangements, including medical expense reimbursements offer significant tax advantages to all employees and result in health coverage being more available, flexible and affordable to all employees. This is not an issue of discretionary income but rather how to provide employees with insurance to protect themselves from health risks and expenses they face regardless of whether or not a cafeteria plan exists. We ask that this area be reviewed and a rule be developed that will allow these type of plans to continue.

• *Retiree Plans*

Many state and local governments offer retirees health care insurance. There are many different permutations as to how the benefits are paid for. Some are entirely retiree paid, others entirely paid for by the former employer or a combination of both. Almost half the states currently make no contribution while 16 states pay full cost for single coverage. One important reason for offering these benefits is to allow retirees to purchase health care at group rates. This cost savings measure, whether or not the former employer pays a portion of the premium, is used to encourage retirees to purchase health coverage. Under the bill if the retiree pays an amount that exceeds the allowable employee contribution, the benefits will become taxable to the highly compensated retiree, thereby discouraging the purchase of health care coverage. An undesired effect could be elimination of the benefit to future retirees and increased strain on the Medicare system. We encourage that retiree health care plans be given special considerations to avoid any unintended adverse behavior.

FEWER COMPLIANCE OPTIONS FOR PUBLIC EMPLOYERS

The private sector has many more options available to it for complying with Section 89. They can drop benefits entirely, switch to employee paid benefits or gross-up the salaries of the highly paid to compensate them for any additional tax that must be paid on excess benefits. Public employers have fewer options. Benefits are generally viewed as a contractual right of employment in the public sector and are set by legislative means making diminishment or elimination nearly impossible. Moreover, budget constraints make the "grossing-up" option fiscally out of reach.

TREATMENT OF STATE AND LOCAL GOVERNMENTS UNDER SECTION 89

Mr. Chairman, the differences I have discussed strongly suggest that selective treatment under Section 89 be provided for state and local governments. Although we clearly understand the intent of the law—not to federally subsidize discriminatory benefits—we remind the Committee that state and local government employee benefit contributions are not deductible expenses for public employers but are a direct cost to state and local governments. Therefore, we provide benefits to our employees without federal incentives and for good public policy reasons and through an open public process.

I appreciate the opportunity to testify today. I would be pleased to answer any questions you may have.

PREPARED STATEMENT OF BRUCE CARSWELL

Mr. Chairman and members of the Committee, my name is Bruce Carswell. I am Senior Vice President—Human Resources & Administration of GTE Corporation. I appear today on behalf of The ERISA Industry Committee and The Section 89 Coalition. I am accompanied by Grant withers, GTE's Director of Benefits, and by John M. Vine, of Covington & Burling, Counsel to The ERISA Industry Committee.

The ERISA Industry Committee, commonly known as ERIC, is an association of more than 120 of the Nation's largest employers. ERIC's members provide broad-based employee coverage under a wide variety of health and other benefit plans. More than 25 million Americans are covered by ERIC's members' health plans.

The Section 89 Coalition is a voluntary coalition of employer groups such as ERIC, the Association of Private Pension & Welfare Plans ("APPWP"), and the Washington Business Group on Health ("WBGH"), individual large and small employers, managed health care plans, insurers, and benefits consultants that have banded together for over two years to communicate their concerns about Section 89 to the Congress and the Administration.

For over two years, ERIC and The Section 89 Coalition have been in the forefront of the efforts to reform Section 89 to make it both manageable *and* effective. We do

not think that tax-favored health benefits should be exempt from nondiscrimination rules.

We very much appreciate the fact that the Chairman and other members of the Committee have recognized the serious problems that Section 89 has created. We are gratified by the Committee's willingness to consider making major changes in the statute. We salute Senator Pryor and the other sponsors of S. 654 for their ground-breaking efforts to provide a simplified alternative to Section 89. These efforts recognize what many employers have been saying all along: that nondiscrimination rules can be effective without being oppressive, that equity does not necessarily require complexity.

We have long advocated a design-based approach to testing for discrimination under Section 89. We believe that a design-based discrimination test can assure broad availability of affordable health care coverage to employees at all pay levels.

We have followed closely the progress of H.R. 1864, which is now being considered by the House Ways & Means Committee. H.R. 1864 embraces a number of the concepts that we have endorsed:

1. H.R. 1864 provides relief for all employers, regardless of their size and regardless of whether they are in the private sector or in the public sector. We oppose carve-outs for specific groups of employers.

2. By focusing on the *availability* of affordable health care coverage, rather than on actual coverage, the bill substantially reduces the data gathering burdens imposed by current law.

3. By eliminating the "sworn statement" and family status rules of current law, the bill markedly simplifies plan administration and avoids unwarranted intrusions into employees' private lives.

4. By returning to the prior law nondiscrimination rules for group-term life insurance plans, the bill recognizes that rules designed for health benefits do not work when they are extended to other benefits.

On the other hand, we also think that H.R. 1864 raises a number of problems that require correction. Let me mention our principal concerns. We ask the Committee to take these concerns into account as it develops its own Section 89 legislation.

The 90 Percent Test. While we strongly believe that employer-provided health coverage should be broadly available, we also believe that the bill's 90 percent availability standard is too high. We are concerned that when the 90 percent standard is combined with a number of the bill's other provisions—particularly its treatment of leased employees and its elimination of the separate testing rule—many employers that offer broad-based health plans to their employees will not be able to meet the 90 percent standard. To compound the problem, if an employer fails to meet the 90 percent standard by as little as one tenth of one percent, the full force of the bill's discrimination penalties will apply.

We urge that, at the very least, the 90 percent standard be reduced to 80 percent. An 80 percent test would strongly advance the objective of providing broadly available, affordable health care coverage.

Indexing. The bill indexes the maximum employee premiums to wage inflation. The maximum premiums should be indexed to increases in the cost of medical care, not to wages. If the maximum premiums are indexed to wages, increases in the cost of medical care could drastically reduce the employees' share of the cost of an affordable health plan. By contrast, indexing on the basis of the medical component of the Consumer Price Index would preserve the allocation of health care costs between employers and employees that H.R. 1864 envisions.

Nondiscriminatory Provisions Test. The bill provides that the employer's health plan may not discriminate (by its terms or in operation) in favor of highly compensated employees. We have no objection to this principle. However, the pamphlet that the Joint Committee staff prepared for the House Ways & Means Committee (JCS–9–89 at page 19) indicates that this rule might not be satisfied unless at least 50 percent of the plan's eligible employees are nonhighly compensated. We strongly object to this apparent resurrection of one of the complex percentage tests imposed by present law. The currently proposed Internal Revenue Service regulations show how, as a result of the Service's aggregation rules, a seemingly simple 50 percent test can mushroom into a complex and burdensome web of regulatory requirements. See Prop. Treas. Reg. § 1.89(a)–1, Q&A–4(d)(1).

Leased Employees. The bill provides that leased employees do not have to be counted if the leasing company makes available affordable core health coverage. This provision does not go nearly far enough in addressing a very serious problem. The Treasury's proposed leasing regulations have completely failed to provide the specific definition that employers need. In most cases, an employer simply cannot determine who its leased employees are. For example, under current law, it is im-

possible to determine whether a company's leased employees include the employees of its suppliers, the employees of a construction company that it hires to build a plant, or the employees of a commercial laundry that it uses to launder the uniforms worn by its own employees.

To make matters worse, the regulations also have gone beyond the intent of Congress to treat as leased employees many individuals who never were intended to be covered. For example, under the regulations, the employees of the U.S. Postal Service in a small town can be treated as the leased employees of a large company with a headquarters located in the town.

We strongly urge that the Committee take action to provide that leased employees will not be taken into account until plan years that begin at least one year after the publication of the final employee leasing regulations. In addition, we will be pleased to continue to work with the Committee and the Administration to develop a specific and workable definition that is targeted at the abusive cases that were the objects of the leased employee provision.

Flexible Benefit Plans. We also are concerned by H.R. 1864's treatment of flexible benefit plans. Flexible benefit plans allow individual employees to choose the benefits that best suit their individual needs. In an era of a changing work force and the two-earner family, employers have found that giving employees a say over the benefits they receive is welcomed by employees at all pay levels.

Employers also have found that flexible benefit plans are a key part of their efforts to combat the rising cost of health care. Nondiscrimination rules should not impede employers' battle against health care cost inflation.

We recognize that flexible benefit programs present especially difficult problems under a test based on benefit availability. We will be pleased to work with the Committee to develop solutions to these problems.

Once-a-Year Testing. We also are concerned that H.R. 1864 requires unnecessary and costly continuous testing of the coverage provided to every highly compensated employee in the work force. As it is currently written, the bill requires an employer to measure the coverage received by each highly paid employee throughout the year. We urge that the Committee permit once-a-year testing of the coverage provided to highly compensated employees, as in S. 654.

If the only changes in coverage during a year are attributable to changes in family status or to elections made during the plan's annual "open season," and if the plan satisfies the bill's nondiscriminatory provisions test, once-a-year testing will adequately measure the plan's benefits. Of course, when a new employee is hired, or when an existing employee terminates employment, the employee should be allowed to prove that the coverage that he actually received was less than the coverage that he is treated as receiving under once-a-year testing. In addition, if an employer takes action to amend its health plan to change the design of the plan in mid-year, it may be appropriate to require separate testing for the period before the change and for the period after the change.

Former Employees. H.R. 1864 delays the rules for former employees for one year. Although we welcome the one-year delay, Section 89 should not apply to former employees at all until Congress fashions appropriate rules for them. Unlike current employees, former employees do not have regular contacts with their former employers. As a result, most employers do not have the information that will be required if the availability standards that apply to current employees also are applied to former employees.

This critical issue should not be left to regulations. We urge that former employees be excluded from testing altogether, pending the outcome of congressional study of the issue.

Part-Time Employees. H.R. 1864 increases the cutoff figure that differentiates a part-time employee from a full-time employee from 17½ hours per week to 25 hours per week. In our view, the 25-hour figure is far more appropriate than the current, unreasonably low figure of 17½ hours. However, in order to give employers a reasonable transition period to phase into the new law, the Committee should provide that the cutoff figure is 30 hours for 1989, 27½ hours for 1990, and 25 hours for 1991 and subsequent years, as in S. 654. The phase in will give employers the time they need to modify their plans to conform to the new requirements.

Separate Lines of Business. The separate line of business and separate operating unit provisions were a critical component of the Tax Reform Act's new coverage and nondiscrimination requirements both for pension plans and for employee benefit plans covered by Section 89. In most instances, in order to rely on the separate line of business and separate operating unit provisions, an employer must either comply with Internal Revenue Service guidelines or obtain a ruling or determination letter from the Service. Although the separate line of business provisions became effective

at the beginning of 1989, the Internal Revenue Service has yet to issue even proposed guidelines or regulations. The Service also refuses to issue rulings or determination letters on separate line of business and separate operating unit issues.

Because the separate line of business and separate operating unit provisions are an integral part of the new coverage and nondiscrimination rules, employers need immediate relief. They cannot be asked to wait any longer for the Internal Revenue Service to issue regulations or rulings.

The Committee should provide that employers may rely on a reasonable good faith interpretation of the statute in identifying their separate lines of business and separate operating units. Reliance on a reasonable good faith interpretation should be permitted until plan years that begin at least one year after the Internal Revenue Service *both* issues *final* regulations *and* begins to issue rulings on separate line of business issues.

H.R. 1864 also requires an employer with separate lines of business to adopt a single testing day for all of its separate lines of business. We urge that this rule be changed, so that each line of business and separate operating unit may adopt a testing day that is appropriate for its business and its workforce. A testing day that is appropriate for one line of business with one employment pattern might well be inappropriate for another line of business with a quite different employment pattern. As a result, unless the single testing day requirement is changed, an employer in multiple lines of business could be required by the bill to adopt a uniform testing day that, in some of its lines of business, causes the employer to violate the nondiscriminatory provisions requirement. *See* Prop. Treas. Reg. § 1.89(a)-1, Q&A-1(c)(1).

Separate Testing Rule. H.R. 1864 eliminates the separate testing rule that now appears in Section 89(h)(5). Under the separate testing rule, if an employer chooses to provide health coverage to a group of employees who otherwise could be excluded from testing (for example, because they have not yet completed six months of service), the employer may apply the nondiscrimination requirements separately to the otherwise excludable employees (in this case, employees with less than six months of service).

The Committee should preserve the separate testing rule. Elimination of the separate testing rule makes it significantly more difficult for an employer to satisfy the percentage availability test (90 percent under the bill) and affirmatively discourages an employer from making health coverage available to groups of excludable employees. It makes no sense for the nondiscrimination rules actually to discourage employers from providing health coverage to any employee who is otherwise excludable from Section 89 testing. If the eligible group of excludable employees satisfies the statute's nondiscrimination standards, the excludable employees should not be required to be taken into account in applying Section 89 to the employer's nonexcludable employees.

Union-Represented Employees. H.R. 1864 requires separate testing of union-represented employees. Although this rule will be useful in many cases, it also will make it more difficult for many employers to satisfy the bill's nondiscrimination standards. A large percentage of an employer's nonhighly compensated workforce often consists of union-represented employees. If the union-represented employees are excluded from testing the employer's nonunion workforce, the employer will get no credit for the fact that it provides health benefits to many nonhighly compensated union-represented employees and will be required to satisfy the percentage availability test solely with respect to its nonunion workforce. When combined with the bill's stringent 90 percent test, the bill's elimination of the separate testing rule, and the employee leasing provisions, the bill's treatment of union-represented employees will make it unnecessarily difficult for such an employer to satisfy the bill's availability requirement.

Accordingly, we urge that an employer be given the option to test its union-represented and nonrepresented employees on a combined basis. In order to prevent any possible abuse, the Committee could provide that the employer's election would be revocable only with the consent of the Commissioner of Internal Revenue.

An alternative approach would be to require separate testing for union-represented employees, but to give the employer an election with respect to its nonrepresented employees. The election would allow the employer to choose to test its nonrepresented employees either (a) by disregarding the employer's union-represented employees or (b) by taking into account both its union-represented and its nonrepresented employees. Under this approach, union-represented employees always would be subject to separate testing. By contrast, depending on the employer's election, nonrepresented employees either would be tested separately or would be tested after taking into account the employer's union-represented employees.

Accidental Death and Dismemberment and Business Travel Accident Coverage. The Internal Revenue Service's proposed regulations under Section 89 provide that accidental death and dismemberment ("AD&D") and business travel accident ("BTA") benefits are health benefits for purposes of Section 89. See Prop. Treas. Reg. § 1.89(a)-1, Q&A-1(f)(1)(ii). However, the nondiscrimination requirements of Section 89 do not make sense when applied to AD&D coverage. Unlike traditional health coverage, AD&D coverage is generally provided in proportion to compensation. In consequence, the cost of AD&D coverage is directly proportionate to pay. The Committee should provide that as long as AD&D coverage is provided in proportion to pay, it will not be considered to be discriminatory. The Committee also should make clear that BTA coverage is a de minimis fringe benefit that is excludable from gross income pursuant to Section 132(a)(4) of the Code.

Qualification Requirements. H.R. 1864 makes no substantive change in the qualification requirements that currently appear in Section 89(k). We urge that if the Section 89 nondiscrimination rules apply only to health plans, the qualification requirements should likewise be restricted to health plans. Moreover, there is no justification for applying the qualification requirements to such fringe benefit programs as employee discounts and company cafeterias.

Qualification Sanctions. The bill imposes a new sanction for violation of the qualification requirements that currently appear in Section 89(k). Under the bill, an employer with a plan that violates the qualification requirements will be subject to an excise tax of 34 percent of the amounts paid or incurred under the plan during the year.

We consider the excise tax to be a more appropriate sanction than the adverse income tax consequences that current law imposes on employees. However, the 34 percent tax rate is excessive, and is far higher than the marginal income tax rate that applies to a typical employee under current law. Furthermore, because the excise tax applies to *all* of the amounts paid or incurred under the plan, the base against which the tax is applied normally will be both extremely difficult to determine and wholly disproportionate to the severity of the violation. We strongly urge that a more refined and discriminating approach be applied.

When Congress originally enacted the "COBRA" health care continuation requirements, it imposed a similarly undiscriminating sanction (disallowance of all the employer's health expense deductions), and soon found it necessary to adopt a more refined approach. We urge the Committee to adopt a more refined approach from the outset in this case.

Taft-Hartley Plans. As described in the immediately preceding comment, H.R. 1864 imposes a 34 percent excise tax upon an employer that participates in a plan that violates the qualification requirements. Imposing a penalty on the employer is unjustified where the employer participates in a Taft-Hartley plan that is administered by an independent board of trustees. Under a Taft-Hartley plan, the trustees are required by ERISA to act independently; they are not the agents of the union or the participating employers. *See NLRB* v. *Amax Coal Co.*, 453 U.S. 322 (1981). Accordingly, the Committee should provide that the tax does not apply to an employer merely because it participates in a Taft-Hartley plan that violates the qualification standards.

Section 501(c)(9) Trusts. Under current law, a voluntary employees' beneficiary association ("VEBA") that is exempt from tax under Section 501(c)(9) is subject to an excise tax if a "discriminatory employee benefit plan (within the meaning of section 89) is part of" the VEBA. The Committee should make clear that as long as the employer satisfies the bill's broad availability requirement, the excise tax will not be applied simply because some highly compensated employees are required to recognize income pursuant to the bill's 133 percent test. If an employer makes affordable core health coverage available to the specified percentage of its nonhighly compensated workforce, the employer should not be considered to maintain a "discriminatory employee benefit plan" for purposes of the excise tax.

Valuation. H.R. 1864 provides that the value of coverage provided by a health plan will be determined under procedures to be prescribed by the Treasury. The Committee should allow an employer to elect to use premium cost as determined under the health care continuation rules or to use any other reasonable valuation method in lieu of employer premiums. This approach is permitted, but only on a temporary basis, by the Internal Revenue Service's proposed regulations; it permits employers to use the valuation method that is most appropriate to the circumstances of their individual plans and, where appropriate, to rely on the same method that they use for health care continuation purposes.

Legal Enforceability. H.R. 1864 makes no substantive change in the requirement currently imposed by Section 89(k)(1)(B) that an employee's rights under a plan be

"legally enforceable." However, the Internal Revenue Service's proposed regulations have taken the "legally enforceable" requirement to an unnecessary and impractical extreme. Many employee benefit plans, and health plans in particular, inevitably call for the application of judgment and discretion in plan administration. For example, a health plan might exclude coverage for "experimental" or "cosmetic" procedures. Although these terms are not defined precisely, they *are* legally enforceable. If the provisions are administered in an arbitrary or inconsistent manner, an employee who is adversely affected will be in a position to enforce his right to obtain coverage under the plan.

The regulations do permit the exercise of "administrative discretion," but only to the extent that the discretion is based solely on "clearly defined and ascertainable criteria." The Committee should provide that the legal enforceability standard does not always require that discretion be exercised under "clearly defined and ascertainable criteria" and that the application of judgment and discretion under objective and nondiscriminatory guidelines is permissible.

Dependent Care. H.R. 1864 provides that group-term life insurance benefits will be subject to the nondiscrimination provisions established by prior law, but fails to include a comparable provision for dependent care assistance. The bill should provide that dependent care assistance also will be governed by the nondiscrimination standards in effect prior to the enactment of Tax Reform.

Effective Date of Employee Notification Requirements. The Internal Revenue Service's proposed regulations provide that the employee notification requirement currently imposed by Section 89(k)(1)(C) requires notice to be given by July 1, 1989, in most cases. See Prop. Treas. Reg. § 1.89(k)-1, Q&A-5(g)(4). Although the Tax Reform Act was enacted in October of 1986, the Service did not issue its proposed regulations until March of this year, approximately two and one-half years later. In view of this delay, it is essential that the Congress extend, until January 1, 1990, the deadline for compliance with the notification requirement. Employers cannot reasonably be expected to comply with the notification requirements within the truncated four-month period allowed by the proposed regulations.

Phased Implementation. H.R. 1864 is effective in 1990 and permits an employer to choose either current law or the new rules for 1989. In most instances, however, compliance with current law is a recordkeeping and data collection nightmare and an impractical alternative for 1989. Although the bill's nondiscrimination standards do not present the same practical difficulties for *future* years, it is now too late for employers to adjust their plans retroactively to the beginning of 1989 to comply with the bill. Accordingly, the Committee should phase in any new standards by prescribing less stringent standards for 1989.

Mr. Chairman, we thank you for giving us an opportunity to present our views to the Committee. We will be happy to respond to any questions that you or the other members of the Committee might have.

PREPARED STATEMENT OF SENATOR JOHN H. CHAFEE

Mr. Chairman, I would like to express my thanks to you for scheduling this hearing on a very important subject. Section 89 of the Internal Revenue Code was created by the Tax Reform Act of 1986, and has been the subject of a great deal of controversy. This section was incorporated into the Tax Reform Act to justify the federal tax subsidy given to employer-provided employee benefits by ensuring that all employees are treated equally.

The Joint Committee on Taxation has estimated the annual cost to the federal government of excluding the cost of employer-provided fringe benefits to be $32.6 billion in fiscal 1990, and projected to increase to $50.8 billion in fiscal 1994. Given the enormous size of this federal tax expenditure, I believe the general intent of the law is fair and rules such as these are necessary.

The purpose of Section 89 is to require coverage of employees who are not highly compensated that is substantially similar to the coverage enjoyed by highly compensated employees. Questions about the equality of employee health coverage arose after studies showed that more than half of American citizens without health insurance were employed by companies that had an established health plan. It is clearly apparent that these rules have become extremely complicated and impose an unreasonable administrative burden on the employers who provide fringe benefits to their employees. The concerns about the costs of complying with the complex section 89 eligibility tests must be adequately addressed to fulfill the original intent of the law.

It is important for us to develop nondiscrimination rules that can be complied with by businesses, administered by treasury and the IRS, and which will justify the

Federal tax subsidy for employee benefit plans. I am reluctant to support outright repeal of Section 89, however, I believe we must do something to relieve the complex administrative burden that has been placed on American businesses by these rules. Outright repeal of Section 89 would reopen the compromise developed in 1986 and put the whole issue of taxation of fringe benefits back on the table.

Mr. Chairman, I believe these hearings are an important first step in the development of substantial modifications to reduce the complexity of these rules. We have an extensive and very impressive list of witnesses, I look forward to hearing their testimony on how we can make these rules workable. I would also like to hear their views on the various bills that have been introduced this year to modify, repeal or delay the implementation of Section 89.

Prepared Statement of Kathi Child

INTRODUCTION AND OVERVIEW

I am Kathi Child, Manager of Benefits Development for the J.C. Penney Company, Inc. I am presenting this statement on behalf of the Penney Company and seven other general merchandise retailing companies which are members of the Retail Tax Committee of Common Interest (the RTC), including BATUS Retail Division, Carson Pirie Scott & Company, Carter Hawley Hale Stores, Inc., Federated Department Stores, Inc., R.H. Macy & Company, Inc., The May Department Stores Company, and Sears Roebuck and Co.

The Retail Tax Committee members are pleased to offer our comments regarding current section 89. We applaud the Committee's willingness to revisit section 89 to seek an approach which meets the public policy objective while imposing a simpler and less harsh set of rules and tests. This statement offers our recommendations in support of your simplification effort. We look forward to the development of a final bill which will address the major controversial issues and will resolve additional technical problems in section 89.

We support the "design-based" concept which has received considerable attention in recent weeks. We believe that this offers the best means for providing an equitable and simple alternative to the current statutory framework. In this context, we support the general direction and specific substantive provisions of both Senator Pryor's "Section 89 Simplification Act" (S. 654) and the simplification proposal (H.R. 1864) introduced by several members of the House Ways and Means Committee. Using the general framework proposed in these bills, we are presenting three proposals which we urge be included in any simplification measure. These proposals deal specifically with the 90 percent eligibility test contained in-both bills, and include (i) enacting a "true exclusion" for various categories of excludable employees (such as part-time employees, those under 21 and those with less than six months of service); (ii) retaining the separate testing rule for excludable categories allowed under current section 89(h) (5); and (iii) reducing the 90 percent threshold and/or eliminating the "cliff effect" of failing to reach that threshold. Other matters are presented in a more detailed technical appendix which is attached to this statement.

I. HISTORICAL PERSPECTIVE AND CURRENT LEGISLATIVE PROCESS

Given the morass of issues facing taxpayers who were following the 1986 reform measure, many taxpayers—including RTC companies—did not give much attention to new section 89 until well after its enactment. Unfortunately, most of the legislative and regulatory efforts to ease the identified problems, while still allowing for as much employer flexibility as possible, have made current section 89 exceedingly complex.

To date, there has been extensive discourse between members of Congress, the technical staffs and the private sector concerning both the problems which company executives have identified and the objectives which the Congress considers important. The receptivity to our concerns by this Committee and your staffs suggested that there was a possibility of revising some of the features of section 89 which have caused us the most trouble. Therefore, we have preferred the approach of seeking substantial revisions and simplifications in section 89 to that of supporting total repeal. The introduction of measures such as S. 654 and H.R. 1864 presents us with an opportunity to assess the substance of potential proposals and imposes an obligation to participate in the process with responsible recommendations.

II. EMPLOYMENT AND BENEFITS IN THE RTC COMPANIES

The retailing industry's workforce is a substantial one. The larger RTC members have 300,000 to 500,000 people employed at various times during a normal year. All of our member companies have at least 35,000 employees on the payroll each year, which probably exceeds even the typical *large* manufacturers and other service sector employers. By themselves, these numbers would not seem to require anything more than a proportional increase in administrative work to process benefits forms and perform other services which employers in other industries must perform with shorter payroll lists. But that assumes a relatively stable and full-time work force within the industry. In fact, the composition of the retailing work force—at least as represented by the RTC member companies—is very diverse.

Of these large numbers of total employees, some 50 to 60 percent are part-time employees (meaning that they work less than 40 hours per week). From surveys and other data sources, we know that virtually all of our part-time employees are in four general categories—second wage earners in a household, "moonlighters," students and retirees. In these contexts, the part-time employee is not looking to the retailing company for health care benefits which would be available to a full-time employee. Instead, that person is covered either by the plan of the primary wage earner, of the full-time employer, of the parents or the former employer.

In addition, a percentage of the total payroll list in any given year is comprised of seasonal employees who are looking for work at selected times of the year—for example, only during holiday seasons or during their vacation periods. Furthermore, the turnover of employees within their first few months for both full and part-time employees is substantial in this industry. A new employee is much more likely to leave the job during the first several months than is the employee who has been with a company for a year or more.

These facts present retailing management with serious problems. It is clear that full-time employees will be offered health care plans by RTC companies and others of similar size, because that is simply what is required to attract *and hold* a stable group of long-term employees today, whether full or part-time. But these employees may constitute as little as 25 percent of the names on a payroll during each year. To offer coverage to part-time employees who either (i) almost certainly have coverage from another employer, or (ii) are likely to leave within a few months, or (iii) will work relatively few hours per week, or (iv) will work only at certain seasons of the year would be an extreme administrative burden which would be incurred for no business or public policy purpose because coverage is not wanted, needed or likely to contribute to the hiring of a permanent employee.

RTC member companies have long focused on what we have considered to be the principal objective of fair benefits packages, even before the enactment of section 89, namely the development of health care plans which offer nondiscriminatory benefits to the stable workforce upon which we depend to remain in business. Our basic health care plans tend to have a high percentage contribution by the company—65 to 75 percent—and all covered employees receive the same employer-paid benefits.

III. ISSUES TO BE ADDRESSED

In the context of the composition of the work forces of RTC companies and the generally nondiscriminatory nature of the health care plans provided by these companies, we offer the following comments on issues which are addressed in the varying legislative proposals regarding section 89 and three recommendations for revisions that should be included in any simplification measure devised by this Committee.

A. The "Part-time" Employee

The exclusion of art-timers from the computations under section 89 has been our highest priority. Current law allows the exclusion only of those who work far less than *half-time*—i.e., less than 17½ hours per week—rather than those who work part-time in the truest sense, meaning those who do not work approximately 40 hours per week.

The 25-hours per week standard in both S. 654 and H.R. 1864 is the primary improvement which those bills would make to the substantive rules in current law, from our perspective. This would bring the definition much more into line with the realities faced by our companies every day. To provide time for plans to be adjusted before the next plan year, we urge that Senator Pryor's phase-in in S. 654—30 hours for 1989, 27½ hours for 1990 and 25 hours thereafter—be adopted.

B. 90 Percent Eligibility Requirement

One of the principal complicating features of current section 89 is the multitude of percentage tests which a plan must meet to avoid sanctions for the highly compensated employees. It is ironic that the benefits tests which were thought to be the heart of the nondiscrimination concept—i.e., the tests which require that the highly compensated not be offered employer-paid benefits which exceed various ratios when compared to the employer-paid benefits offered to the nonhighly compensated are passed by RTC companies generally. As noted above, our companies have long tended to offer plans which provide the same or very similar benefits to all covered employees. It is the 90 percent eligibility test which has posed the principal problem, since defining the base of employees to which the 90 percent test must be applied is troublesome, given the workforce composition.

The problem would continue in proposed section 89 under both S. 654 and H.R. 1864. The absence of a "true exclusion" for the various categories of excludable employees is the principal reason. Deletion of the separate testing rule in current section 89(h)(5), as proposed by H.R. 1864, would also add to the problem.

With payroll lists which have large percentages of part-timers and seasonal employees and people who will not stay on the job logger than a few months, the 90 percent level is a very tough standard to meet unless the base of employees to which it is applied can be limited to a reasonable group. The impact of this threshold is made all the more harsh by the "cliff" effect which requires the highly compensated employees to include in income 100 percent of the employer-provided benefit if the plan fails to comply with the 90 percent eligibility test by even as little as one percentage point.

We urge that the Committee consider the following three recommendations with respect to a 90 percent eligibility test.

1. True Exclusions for Employee Categories

The exclusions under current section 89 for certain groups of employees—part-timers, those who have not completed six months of service, seasonal employees, those under 21—are denied if even one employee in that category is eligible for the plan. This means that any employee who works less than 25 hours a week or is under 21 or who has worked for less than six months but who is eligible for the health plan of a particular company forces the employer to include *all* such persons in the base to which the 90 percent eligibility test is applied. This result would be continued under S. 654 and H.R. 1864 as well.

If there are discriminatory "games" which can be played with the exclusions—particularly with the "six months service" category—this problem should be addressed to the extent possible by the statute, by legislative history and by the resulting regulations. The inclusion of all otherwise excludable employees due to the eligibility of a few is too extreme a rule.

This is particularly the case with respect to part-time employees. RTC companies depend heavily on part-time employees whom we can count on as members of a permanent workforce. As noted earlier, it is important that this critical element of a stable workforce be treated as much like our permanent full-time workforce as possible. RTC companies may make the business judgment that part-time employees who clearly have become permanent employees should be treated like full-time employees to the extent possible. This can result in the eligibility of employees who normally work less than 25 hours per week but only after it is clear that they are permanent employees. However, by making this legitimate distinction, the employer would be forced to include *all* part-time employees in the eligibility test, even though it is certain that a very substantial portion of them will not remain with the company for very long. Similarly, a company may have changed its eligibility rules for part-time employees by increasing the hours standard, while grandfathering the part-time employees who were eligible at the time of the change. By continuing to allow these long-time employees to be eligible at a lower number of hours than newer employees, the employer must take all part-timers working the former hours standard into account in the eligibility test.

The extension of benefits eligibility to the permanent part-timers is directly in line with the policy objective of section 89. Furthermore, there is no situation which we have been able to construct in which an eligible part-time employee would be considered a highly compensated employee to whom discriminatory benefits could be offered. To deny the exclusion to the entire category because of the inclusion of permanent part-time employees is too extreme a result. Given that section 89 is intended to encourage broader eligibility for benefits, the "all-or-nothing" rule for excluding part-timers should not be allowed to create pressure to *withdraw* eligiblity from some part-timers in order to save the qualification of the plan in general.

Similar problems arise with respect to employees who have not completed six months of service, who are under 21 years of age who work on a seasonal basis. The volume of turnover among new employees during the first several months is so high that many employers have concluded that offering a plan to such employees does not make good business sense. Allowing those employees who are under 21, those with less than six months service and those with seasonal employment patterns to be excluded represents a sound policy judgment that such employees are the least likely people to become a part of the employer's stable, permanent work force for whom benefits are a relevant matter—particularly when they are not full-time employees. However, extending eligibility to employees in these categories who *are* part of the permanent workforce should not deny the entire exclusion.

We are not aware of any situation in which employees in the under 21 or seasonal categories would be highly compensated employees to whom discriminatory benefits would be offered if such persons were made eligible. Therefore, we urge that the rules be revised to allow for the exclusion of all persons in these categories. It is possible that employers could distinguish between highly compensated and nonhighly compensated employees based on initial periods of service, so there may be a reason to have a somewhat tighter rule in this category than in the others. However, even here, we urge that the denial of the exclusion not be based on an assumption that there is a discriminatory motive at work.

2. Separate Testing

Under current law, certain excludable categories can be tested separately to determine their compliance under section 89 in lieu of the denial of the exclusion for the entire category. We understand that the separate testing rule is contained in original section 89 to mitigate the harshness of the all-or-nothing exclusion discussed above and to provide a basic fairness rule. As presently drafted, H.R. 1864 would delete this provision—subsection (h)(5)—from proposed section 89. We urge that this separate testing approach be retained.

To the extent that highly compensated employees could be favorably affected in some manner by a "true exclusion" discussed above, the separate testing rule allows the nondiscrimination rules to be applied without adversely affecting the employer's plan generally. As long as it can be shown that these people do not turn the general category of employees with less than six months service into a discriminatory category, their presence should not adversely affect the ability of the plan to meet section 89 requirements.

3. Reduced Percentage or Sliding Scale Penalty

While the problems of the 90 percent rule under current law would be reduced using the 25-hours standard for the part-time employees, any deletion of the separate testing rule and/or the absence of the true exclusion push in the opposite direction. Therefore, the 90 percent threshold remains very high.

Two options are available for mitigating the severity of the 90 percent test while still achieving the policy objective and avoiding complications in the administration of the proposed section 89 rules. The simplest approach is to lower the eligibility threshold to something in the 70 to 80 percent range. There is precedent for both numbers; in the pension area, the rules require a qualified pension plan to meet a 70 percent eligibility test, and the proposed regulations for current section 89 apply an 80 percent test in the large employer rules.

But fixing a percentage at 70 percent or any other number presents the same "cliff" effect with respect to the penalty. Failing the test by one percentage point or less still subjects the highly compensated employees who are not receiving a discriminatory benefit to *full* inclusion of the benefit in income.

An alternative approach is to revise the all-or-nothing penalty by lowering the percentage at which the "cliff" occurs and using a simple sliding scale above that percentage. Using the "133 percent exclusion rule" in H.R. 1864, for example, if 90 percent eligibility were to remain the threshold for the maximum exclusion from income and 70 percent eligibility were established as the minimum for partial exclusion, the amount excludable from income by highly compensated employees could be determined using a scale of multipliers applied to the nonhighly compensated employees' benefits. The following table illustrates this approach.

Eligibility Percentage	Multiplier
90 percent	133 percent
85 percent	125 percent
80 percent	115 percent
75 percent	107 percent
70 percent	100 percent
Less than 70 percent	0 percent

In addition, consideration should be given to permitting the use of a higher multiplier (such as 150 percent) if the plan's eligibility percentage reaches above 90 percent.

CONCLUSION

The simplified design-based concept presented in both S. 654 and H.R. 1864 for health plans represents a dramatic improvement over current law. With certain revisions to technical features of the 90 percent eligibility test, we believe that a design-based approach will represent the needed replacement for current law.

TECHNICAL APPENDIX

A. CORE BENEFITS

Several of the bills under consideration adopt a design-based test requiring that core health benefits be made available to rank-and-file employees.

Recommendation: It is important to define the term "core benefits" in the same manner as defined in the proposed Treasury regulations (i.e., as comprehensive major medical and hospitalization benefits). As under present lain, coverage for dental or vision care, and health coverage provided under flexible spending arrangements should not be considered core health benefits. It is also important that core benefits be defined generally because any attempt to define core benefits by reference to required coverages, copayments or deductibles would unduly restrict employer flexibility in plan design.

B. PREMIUM LIMITATIONS

Under several proposals a qualified core health plan is defined in part as a plan which is affordable—i.e., one which does not require employee contributions in excess of stated weekly amounts, indexed for cost-of-living adjustments.

Recommendation: Any premium limitations ultimately adopted should be adjustable to permit an employer to take account of geographic differences in premium costs. In addition (i) the minimum weekly premium should be at least $10 for single coverage and $25 for family coverage; (ii) the premium indexing should be based on a medical, rather than a wage, index; (iii) the premium limitation should not include all pre-tax employee contributions without adjustment for tax savings; and (iv) the premium limitations should be adjusted regarding former employees to reflect higher costs and the adverse selection inherent in retiree coverage.

C. FAMILY COVERAGE

Under several of the pending bills, a "qualified core health plan", may contain separate premium limitations for individual and family coverage. In addition, under at least one bill (H.R. 1864), the computation of the benefit that may be excluded by a highly compensated employee contains a special rule for family coverage.

Recommendation: The term "family coverage" should be clarified to mean coverage for both the employee and the employee's family. In addition, alternative premium limitations should be adjusted on a per dependent basis for family coverage (e.g., employee plus spouse, employee plus one child and employee plus two or more children).

D. VALUATION METHODS

Crucial to the application of any discrimination test is the method used to value benefits. Several of the proposals appear to restrict permissible valuation methods to the value determined under procedures prescribed by the secretary.

Recommendation: Any bill ultimately enacted should confirm that an employer is permitted to use alternative valuation methods including COBRA cost, actual employer cost and values determined under reasonable actuarial methodologies. In addition, to provide certainty to employers, the transitional valuation rules enacted in the Technical and Miscellaneous Revenue Act of 1988 (TAMRA) should be made permanent.

E. EMPLOYEES WORKING LESS THAN 30 HOURS PER WEEK

Several proposals under consideration provide special rules permitting a proportionate increase in the employer-provided benefit and the premium limitations for employees who work less than 30 hours per week.

Recommendation: The term "proportionately increased" should permit an increase for employees working between 25 and 30 hours, based on the ratio of actual hours worked to 40 hours. A 40-hour-per-week standard is needed to accurately reflect the normal work week of a full-time employee receiving employer-provided health coverage.

F. UNION EMPLOYEES

Unlike present law, several proposals would require that section 89 be applied separately with respect to employees included in a qualified bargaining unit.

Recommendation: Permitting separate testing would significantly simplify nondiscrimination testing for union employees. It would be appropriate to exempt union employees from any premium limitations (especially with respect to plans maintained under existing collective bargaining agreements).

G. FORMER EMPLOYEES

Except to the extent provided in regulations, section 89 is to be applied separately to former employees under requirements similar to the requirements that apply to employees. While some of the proposals would delay this requirement until 1990, none define the methodology for applying the tests.

Recommendation: Additional guidance is needed with respect to the treatment of former employees. For example, former employees should be defined with respect to some age and service criteria; the group of former employees against which compliance is measured should be defined; and the premium limitations for such employees should be adjusted to reflect higher costs and adverse selection that are characteristic of this group. In addition, consideration should be given to *permanently* grandfathering former employees retiring before the date that final rules are issued clarifying the application of the tests to former employees. The grandfather rule enacted in TAMRA (under which grandfather protection can be lost if benefits are increased) does not provide sufficient protection to employers. Many employers do not have, and cannot reconstruct, records identifying former employees and whether such employees were highly compensated. Precise guidance on these issues is needed because many of the changes to retiree benefits which are not within an employer's control (e.g., changes pursuant to state mandates or collective bargaining agreements) would deprive the employer of the TAMRA grandfather.

H. PLANS OTHER THAN HEALTH PLANS

Several of the proposals would reinstate for group-term life insurance plans the nondiscrimination rules in effect prior to the Tax Reform Act of 1986.

Recommendation: Providing that group-term life insurance plans are not subject to the section 89 rules is a significant simplification. However, accidental death and dismemberment plans and business travel accident plans should also be exempt from the nondiscrimination rules of section 89.

I. SALARY REDUCTION

One of the key issues in applying the section 89 nondiscrimination rules to cafeteria plans is the treatment of salary reduction contributions. Under present law and at least one proposal (H.R. 1864), salary reduction contributions are treated as employee contributions for certain purposes and as employer contributions for other purposes.

Recommendation: The effect of treating salary reduction contributions in an inconsistent manner results in a "whipsaw" effect with respect to a highly compensated employee whose coverage is funded, in part, through salary reduction contributions. For example, assume that an employer makes a health plan worth $1,500 available to all employees and that highly compensated employees pay the full $1,500 on a salary reduction basis. Assume further that nonhighly compensated employees pay $500 on a salary reduction basis and that the employer pays the remaining $1,000. Under H.R. 1864, highly compensated employees may exclude no more than 133% of the $1,000 benefit permitting a maximum tax-free benefit of $1,330. Because the highly compensated employees are treated as receiving employer-provided benefits equal to $1,500, they will have $170 of taxable income. This result is unfair, given that highly compensated employees and nonhighly compensated employees receive identical coverage, and that substantial employer contributions are made on behalf of nonhighly compensated employees but not highly compensated employees.

Any proposal ultimately adopted should (i) consistently treat benefits attributable to salary reduction contributions as employer-provided benefits; (ii) permit this consistent treatment, provided that the core benefits attributable to actual employer contributions equal or exceed the core benefits attributable to salary reduction contributions; or (iii) if this whipsaw effect must be retained, permit a greater disparity between benefits available to rank-and-file employees and exclusions available to highly compensated employees.

J. QUALIFICATION SANCTION—34 PERCENT EXCISE TAX

It is very difficult to devise an appropriate sanction for plans that fail to satisfy the qualification rules. Pending proposals suggest various alternatives, including limiting the number of employees potentially subject to tax, limiting the dollar amounts potentially subject to tax, or replacing the income tax on employees with an excise tax to be paid by employers.

Recommendation: We support the imposition of an excise tax in lieu of imposing additional income taxes on employees. However, the provisions of the proposed Treasury regulations relating to severable coverage should apply in determining the amount of the excise tax. Additional relief should also be provided for situations (such as those involving multiemployer plans) where the employer may not have direct control over whether the qualification requirements are satisfied. Furthermore, consideration should be given to capping the penalty.

K. VEBA RULES

Under section 4976(c), an excise tax equal to 34 percent of the lesser of (i) the fund's discriminatory benefits or (ii) the fund's investment income is imposed on an employer that maintains a welfare benefit fund (e.g., a VEBA) which includes a discriminatory employee benefit plan.

Recommendation: If a design-based test is adopted, the 4976(c) excise tax should be imposed based upon a failure to satisfy such test. However, if the exclusion for highly compensated employees is also limited, the excise tax should not be imposed on the payment of benefits in excess of the benefit limit.

PREPARED STATEMENT OF SENATOR DAN COATS

Mr. Chairman, I thank you for holding this hearing. There are few issues on which I have received more letters and phone calls than on the problems small business owners and employees face in Indiana than on Section 89.

Encouraging employers to enact and maintain employee benefit plans that are balanced and fair is a worthwhile goal, yet the present law has the opposite effect.

Section 89 of the internal revenue code was designed and enacted with the intention of promoting fairness in employer-sponsored benefit plans by discouraging plans that favor highly compensated employees over other employees. Yet, the statute as it now reads is too complex and too expensive to administer. The costs and risks to an employer of administering a benefit plan under the gun of section 89 are prohibitive for most small businesses. Section 89 will have the effect of forcing many small businesses to simplify their plans by reducing health benefit options and cutting back on subsidized health coverage. Section 89 will require businesses to collect and analyze a massive amount of information about their benefit plans in order to comply with the new tests that are established.

Both employers and employees could face significant new taxes under Section 89 if the employer fails to fully comply with any of its many and complex provisions. For example, an employer that failed to meet the qualification requirement in a situation where his employee had received $100,000 in benefits for catastrophic medical expenses during the preceding year could be compelled to pay an excise tax of $28,000 just for that one employee, while the employee himself could also be taxed on the entire $100,000. The results of section 89 will therefore be to punish both employers and employees for providing and taking part in a health benefit plan. This makes for bad public policy.

Section 89 creates many more problems than it attempts to solve. The solution to the problems section 89 creates is to simply repeal section 89. Hopefully these hearings will lead to an end of section 89 and the threat it represents to maintenance and well being of small business benefit plans.

Thank you.

PREPARED STATEMENT OF RON DANILSON

Mr. Chairman, I am Ron Danilson, Associate Director—Group Underwriting with responsibility for product development and legislative compliance activities for The Principal Financial Group headquartered in Des Moines, Iowa. The Principal Financial Group is a family of insurance and financial services companies with assets of more than $23 billion. Its largest member company, Principal Mutual Life Insurance Company, is currently the 7th largest life insurance company in the nation ranked by premium income. The Principal is also a major underwriter of employer sponsored life and health insurance and provides coverage for over 60,000 employer groups located throughout the United States. Of this number, some 50,000 are employers with 10 or fewer covered employees whose plans include approximately 360,000 employees and their dependents. I appreciate your invitation to participate in this hearing and to have the opportunity to share with you some of our concerns and our experiences in assisting our customers with Section 89.

We are convinced the current nondiscrimination tests are too onerous and that their attendant rules of application are too complex for most employer group plans. Unless the rules are simplified so that more employers are able to understand and apply the tests, many so-called discriminatory plans will result. Many of our smaller customers are overwhelmed with the law's complexity; they tell us they will simply have the business owner pay the tax rather than attempt to collect data and apply the tests. We are also beginning to receive letters from small employer customers who are dropping their plans specifically because of Section 89. Rules that are difficult for benefit and tax experts to understand are incomprehensible for employers without full-time benefits staffs or without the resources to hire benefits professionals.

We are encouraged by the efforts of Senator Pryor and others to simplify this law. We strongly support the concept of a plan design safe harbor introduced by Senator Pryor as an alternative to the current rules for nondiscrimination testing. We view this as an essential part of any simplification effort. There is, however, one important element included in the design-based alternatives offered so far, that we believe needs to be reconsidered. This is the dollar cap on the amount of employee contributions allowed toward the cost of the health plan. We understand the objective of the cap is to alleviate the affordability problem for low-wage workers. Although we are sympathetic with this objective, the dollar cap creates a number of unintended problems:

a. A common characteristic for many small employer health plans is a less generous employer subsidy for dependent coverage than that normally provided for employee coverage. This is an affordability issue for small employers. A dollar cap that is too low will put the safe harbor financially out of the reach of many small employers. Without the safe harbor, there is less incentive for the small employer to subsidize dependent coverage at all. A better alternative is to require a uniform employer subsidy of dependent coverage set at a percentage of plan costs.

b. The dollar cap ignores health benefit cost differences due to geographic region and to employee age. This will force a more generous employer subsidy in certain areas of the country than for others, and for older workers. A uniform cost sharing percentage would avoid these problems.

c. Health care inflation drives insurance costs and is increasing faster than wages. Without appropriate indexing, the dollar cap will cause additional cost shifting to the employer in order to maintain eligibility for the safe harbor.

d. Some unintended plan design actions that could result from an artificially low cap on employee contributions include:

1. Shift of part of the existing subsidy for employee only coverage to dependent coverage.
2. Reduce the benefits to lower costs to achieve the cap. This could include dramatically increasing front-end deductibles and out-of-pocket limits, or dropping ancillary coverages such as prescription drugs, dental or vision to help achieve the cap.

As an alternative to the dollar cap, we suggest establishing percentage cost sharing limits. The employee contribution could be limited to 50%, of the total health benefits cost for the plan to qualify for the safe harbor.

Section 89 artificially imposes a new definition of part-time employee of 17½ hours per week on all employers and requires these employees be counted in testing. For many of our small business customers, this boils down to a forced financial choice of paying tax on their own benefits since the cost to expand coverage to all part-time employees is a significantly greater financial burden. Business owners who have voluntarily taken steps to provide health benefits to full-time employees may be penalized by Section 89 for failing to cover part-time employees, when Congress has yet to decide on how best to encourage more employers to provide health coverage to their full-time workers. We support the simplification efforts of Senator Pryor and others that exclude part-time employees who work less than 25 hours per week from testing for all employers.

There are a number of other changes included in Senator Pryor's bill (S. 654) and in Chairman Dan Rostenkowski's bill (H.R. 1864) which provide substantial relief. These include: reinstituting the former Section 79 nondiscrimination rules for Group Term Life plans in lieu of Section 89, changing the definition of highly compensated employee to provide relief to counties and cities who have no highly paid officers and the delay of former employee testing.

We also agree that the penalties included in the original law and modified by the proposed regulations for failure to comply with plan qualification standards are excessive and warrant further modification. We are encouraged that both (S. 654) and (H.R. 1864) take steps in this direction. A penalty assessed against the employer is more appropriate in our view than one assessed against employees. Furthermore, we strongly urge this change be expanded to clarify that satisfaction of the written plan rules of ERISA be deemed satisfaction of the written plan rules under 89(k). The proposed regulations appear to add a new requirement on top of existing ERISA rules with no substantive difference in the end result. These regulations will force many small fully insured employers to incur unnecessary additional expense for a new "single written plan document." Employer resources already strained by increases in health care costs should not be required to be spent on this unnecessary duplication for no added benefit to participants. At The Principal Financial Group, we are helping our customers cope with Section 89 in a number of ways:

1. We've established a toll-free number for both our customers and their agents to call for help with Section 89 questions. We received nearly 3,800 calls in the first four months of operation. The questions range from very basic to complex, but reinforce our view that the complexity of Section 89 is contributing to a widespread lack of understanding on the part of small employers.
2. We are also providing our customers and their insurance agents with educational question and answer materials and an informational guide designed to help them collect employee data and apply the tests. We re also offering testing services.

As I indicated earlier, some policyholders are terminating their group plans rather than face the task of compliance. Others are considering this alternative. One customer with nine employees in Dayton, Ohio terminated his group plan and gave each employee an additional $1,500 in pay to go and find their own health benefits. We're quite sure the cost to these employees for coverage will be higher than it would have been on a group basis, if in fact they spend the money on medical insurance. Other examples of statements from policyholder letters include:

—A five employee mining company in Arizona: "Our decision to cancel our Group Coverage was prompted by the IRS Section 89 legislation."

—A 19 employee company in Rhode Island: "The administrative requirements and penalty clauses of Section 89 of the IRS code are too excessive to make continuation of this policy practical."

Finally, I want to emphasize that it is our view that the two simplification bills introduced in Congress repr- ent important initial steps in the necessary task of

eliminating the enormous administrative burdens imposed on employers by Section 89. We offer you our assistance in helping complete this process.

PREPARED STATEMENT OF SENATOR PETE V. DOMENICI

Mr. Chairman and members of the Committee, I want to thank you for this opportunity to share my views with you today.

I want to take a moment to describe some of the specific problems pertaining to Section 89 that the business people in my state have relayed to me. In addition, I would like to make a brief statement about my bill, S. 595, the "Section 89 Small Business Relief Act of 1989."

First, I would like to applaud Secretary Brady for his attention to this issue. On May 1 the Secretary ordered a delay in the July 1, 1989 effective date of the law until October of this year. This will provide relief for employers across the country, but it is not enough. It is an indication of the Administration's willingness to work with Congress to fix the law.

Section 89 was enacted as part of the Tax Reform Act of 1986. With few exceptions, this law requires all employers who offer benefit plans to conduct a series of complex statistical tests to ensure these plans are distributed fairly among all their employees, whether they are highly compensated executives or whether they are rank and file workers.

Mr. Chairman, with 25 million uninsured workers and workers' families in this country, encouraging private insurance coverage is a worthwhile goal. I don't think there is anyone here who would disagree with the intent of Section 89.

The problem is that small businesses, experts in benefit programs, accountants, and attorneys are all finding that they are unable to figure out the rules necessary to comply with the new law.

Approximately two months ago, on March 2, the IRS published regulations to implement Section 89. Those regulations consist of 200 pages of rules for the business people of this country to grapple with. But those 200 pages of rules, confusing as they may be, are nothing compared with the confusion caused by the statute itself.

I applaud the IRS's efforts to clarify this monster known as Section 89. However, employers are still left wondering what they are required to do to comply with the law this year.

In fact, many employers have exhausted every source of information available to them, and now they have begun to telephone my office to see if I can offer them any guidance on whether their plans are in compliance with the law.

Mr. President, these are law abiding taxpayers who *want* to comply with the law. But they can not comply because no one can tell them how. I certainly can't. And I find that situation astonishing and frightening.

Last week I held a "Section 89 Forum" in New Mexico. Albuquerque is a relatively small city, but over 300 people came to share their views and frustrations on this issue.

I was astounded by what I learned. Even with benefits experts, insurance agents, lawyers, and accountants, it is impossible for the employers in my state, or any other state, to get advice that is 100 percent accurate.

Nevertheless, the employers in my state are going to great extremes to comply with this law. I learned in this meeting that for $3,000, plus $20 per employee, "Section 89 benefit testers" will let employers know if their plans are in compliance. Many businesses have already invested large sums of money to comply, and now it seems certain that we in Congress will change the law. I applaud that change. Employers will be glad to know that they may not have to go to this same trouble next year.

One small business owner told me that she was approached by a company that offered to sell her Section 89 software packages for $4,000. $4,000 for *one piece* of software! There was one catch though. She had to buy it before the end of this month, or the price would increase.

So long as the thrust of the law remains in tact, I do not believe new rules and regulations will do much to aid compliance significantly. At best, they leave many unanswered questions and raise new problems for employers who are making decisions concerning employee benefit plans.

I have spoken with many business owners in my state as well as business groups here in Washington. The consensus is clear: Congress should repeal or significantly modify Section 89.

Today I have brought some of the letters I've received from the business people in New Mexico and elsewhere in the United States. I would like to submit them for the record.

It seems there are two types of letters. Some business people say they are aware of Section 89 and they are flabbergasted and outraged. Others aren't even aware of the law or its ramifications.

One small businessman said that he had studied the meaning of the law very carefully and decided the best way for his business to cope would be to drop the company-sponsored health plan and raise everyone's salary by $100 a month. That would allow the employees to decide for themselves whether or not they want to purchase their own coverage or, as this businessman put it, "spend the extra $100 on beer."

Another employer told me "we know we'd pass the tests, but it would cost thousands of dollars and thousands of wasted man hours just to prove it."

One small business woman wrote "we have elected to let sleeping dogs lie. We will not be following through on plans to offer group insurance to our employees. We are very disappointed to have to make that decision. It was a service we *wanted* to provide."

These comments may sound extreme, but they are comments I have heard over and over again. They provide a very accurate illustration of the frustration employers in this country feel.

Mr. Chairman, Section 89 is poor policy, by anyone's judgment. The more I learn about Section 89, the more I think the tax writers set out to correct a *perceived* wrong in the existing Tax Code. I'm convinced that if discrimination exists, it was occurring in large businesses, not small businesses.

I am told by many members of the Chamber of Commerce in Albuquerque that in most cases if businesses can afford to offer benefits to their employees, they offer them to all their employees.

Most small businesses already offer comprehensive benefit plans. Instead of encouraging this, Section 89 serves as a hindrance. The requirements of this law place an unfair burden on all businesses, but especially small businesses because they don't have the resources to deal with the paperwork and compliance issues.

I am aware of an analysis prepared by OMB that estimates it will take approximately 10 hours per firm to comply with Section 89. From what I have heard from the business people in my state, this estimate is ludicrously low. It will take more time than that for them to just read through and understand the 200 pages of regulations, much less collect the necessary data, and perform the testing computations.

I, along with many of my colleagues in the Senate and the House, are concerned that Section 89—even with the regulations—will achieve the opposite effect of what it was intended to do. Employers will be forced to spend exorbitant amounts of money to comply with the law. This is money that they would rather spend on benefits for their employees.

I think that Congress and the Administration are beginning to see the problems associated with Section 89. Treasury Secretary Brady's recent decision to delay the effective date of the law, and the impending penalties, is testament to the fact that the law is flawed.

There are many in Congress who would like to scrap the entire law and start from scratch. I hope we do not have to go to that extreme, but we may.

In 1987, 88 percent of all businesses in my state had fewer than 20 employees. Thus, legislation directed at expanding coverage for the working uninsured must focus on the small business sector because in large part, that is where the problem is most pervasive.

Secretary Brady appeared before the Appropriations Subcommittee on Treasury, Postal Service, and General Government, of which I am the Ranking Republican Member. At this time I explained to him the particular problems Section 89 creates for small businesses. He agreed that an exemption for small businesses, such as the one I have created in my bill, may be necessary.

The bill that I have introduced proposes some very basic changes that will help relieve the burden of this law on small businesses. Briefly I would like to tell the Committee members about my bill. S. 595 would make the following changes:

1. Exempt all small businesses consisting of fewer than 20 employees from Section 89 altogether;
2. Implement a 25-hour standard for part-time employees;
3. Delay the effects of the law for two years;
4. Provide that employers who offer benefits to all employees are in compliance with the law regardless of whether or not the employee chooses to participate in the benefit package.

Mr. Chairman, I would like to thank you and the members of this Committee for giving me this time to voice my concerns about Section 89. I will look forward to working with my colleagues to restore fairness to the law.

PREPARED STATEMENT OF SENATOR DAVE DURENBERGER

Mr. Chairman, it was just three years ago that this Committee unanimously approved the most significant restructuring of the tax code in the nation's history. Included in the massive tax reform bill was a little-noticed change in the rules governing the receipt of tax-free company-provided health insurance. For the first time, the tax exclusion was conditioned on the requirement that employer-provided health insurance be provided on a non-discriminatory basis.

In adopting the Section 89 rules, I think we all recognized that this provision, by itself, would not overcome the problem of access to health insurance for the 37 million uninsured. Yet we believed that it's adoption would expand participation in company-sponsored health insurance and serve as an important step in expanding the number of people who have access to company-sponsored health insurance benefits.

Moreover, when one considers that over the next five years it will cost the Federal Treasury more than $200 billion to allow companies to deduct the cost of health insurance, it should come as no surprise that Congress wants to ensure that the lion's share of this tax subsidy not be skewed in favor of the highest paid executives, officers and owners of these companies.

Unfortunately, Mr. Chairman, while we may all agree on the goals underlying Section 89, I believe that in its execution, the statute and the regulations are far too complex for most businesses to comprehend and comply with. It is for that reason that last December I began to work with Senator Pryor to develop legislation that would substantially simplify the Section 89 testing and coverage rules. In March, we introduced legislation (S. 654) that I believe addresses many of the concerns that have been expressed to me by the business community. I am pleased and complimented to have as many cosponsors on this legislation as we do.

Yet I must concede that the deeper I get into the entire issue of access to health insurance, and the role that business must play in helping to solve that problem, the more I am convinced that the solution offered by our legislation neither resolves all of the legitimate concerns of the business community nor does it satisfactorily address the twin issues of availability and affordability of health insurance in the work place.

For example, we developed the concept of a model simplified health plan that would enable employers to get out from under the maze of the Section 89 testing rules. Using this approach, we tried to address the issues of availability by requiring that a health plan must be made available to at least 90 percent of a company's work force. And we tried to address the issue of affordability by setting an amount of money that lower income employees could afford to pay toward monthly premiums as a test of "discrimination."

Despite our efforts, both Senator Pryor and I recognize that there are shortcomings in this approach. While the $6.70 and $13.40 per week employee contribution limit rules may be workable in some parts of Minnesota and Arkansas, these limits will create severe difficulties for businesses operating in many large cities. Not only does our legislation not take into account health care costs in different regions of the country, but it also fails to address the out-of-pocket costs that employees must incur through co-payments and deductibles. What may appear as affordable health insurance at first glance may on closer inspection turn out to represent unaffordable coverage for many average workers.

Mr. Chairman, I think it is imperative that in our haste to resolve the legitimate complaints of the business community, we should not substitute a set of narrowly restrictive rules that limit an employer's incentive to provide a choice of health plans that fit the varying needs of its workforce. Nor should we write a new set of rules that will discourage employers from adopting health plans that emphasize cost-containment and employee accountability.

I know that the Chairman and every member of this Committee wants to resolve the confusion over Section 89 as soon as possible. Yet at this point I am convinced that we must place the issue of Section 89 in the larger context of how this country is going to resolve the issue of broadening the availability of health insurance to the millions of uninsured, and what role business is going to play in helping to resolve this problem.

Currently, the U.S. Bipartisan Commission on Comprehensive Health Care is serving under a mandate to provide recommendations by the end of this year on how to resolve the problem of broadening access to health care services for all individuals in the country. I am serving on that Commission along with Senators Pryor, Heinz and Baucus. Max and I are its Vice-Chairs. It is our expectation that we will come up with a comprehensive and, most importantly, a bipartisan set of recommendations that we will be able to implement in the next session of Congress.

Mr. Chairman, as I see it, the issues surrounding Section 89 should be subsumed by the recommendations of the Bipartisan Commission. In its deliberations, the Commission must address issues relating to the structure and availability of private health insurance, as well as how such insurance interrelates with publicly funded programs. Specifically, our charge is to recommend how the United States can achieve universal financial access to medical care with most of it coming through the workplace. Whether and how to change today's system of federal tax and other subsidies to employed-financial health insurance so that *all* employers can afford to provide some coverage to all employees is our challenge.

That is also part of the reason for the 1986 tax Act Section 89 provisions. It is for that reason that I would recommend that this Committee consider delaying implementation of Section 89 for one year in order to give Congress the opportunity to consider and implement the Commission's recommendations. In the interim, I would be willing to work with the Chairman and the other members of the Committee to implement one aspect of the Section 89 rules that I think we can all agree should not be delayed.

I would like to see if we could draft a set of rules that addresses two concerns that I think all of us share. It seems to me that if an employer offers coverage to its high paid executives and does not offer coverage to its non-highly compensated employees, the value of the health insurance should automatically be included in the high-paid employee's income. Secondly, if an employer offers more than one type of coverage to its employees, and if a higher percentage of the highly paid employees takes the more generous coverage, the value of the health insurance should be included in the high paid employee's income.

Prepared Statement of Sandy Galef

Thank you Mr. Chairman, we appreciate the opportunity to testify. I am Sandy Galef, legislator on the Westchester County, New York, Board of Legislators and vice chair of the Labor and Employee Benefits Steering Committee of the National Association of Counties (NACo).[1] I am pleased to appear on behalf of NACo and its member counties to discuss the impact of Section 89 on county governments, and to provide our views on the proposed Section 89 Simplification Act, S. 654.

Mr. Chairman we have heard three explanations for why congress enacted the current Section 89 legislation. We have heard it was enacted to discourage discrimination in tax-exempt benefit plans, to expand health insurance coverage to the uninsured, and some have said it was enacted to raise revenues. In any event, we are not convinced that it will accomplish any of these objectives. Instead, in order to avoid compliance problems, Section 89 has caused many employers to seriously consider dropping or reducing health benefits for their highly compensated employees. As a revenue raiser, we believe cost of compliance will far exceed any increased revenues that can be anticipated from Section 89.

Because we do not discriminate and because counties are the payors of last resort for uninsured indigents, NACo strongly favors state and local exemption from Section 89. Our track record in providing equal benefits to our employees and the safeguards against discrimination in the public sector will demonstrate that Section 89 is unnecessary in state and local governments.

Let me point out that we fully support not only the concept but the practice of nondiscrimination in employer provided tax-exempt benefit plans. If you examine the facts, you will find that state and local governments have for many years offered their employees the same level of benefits, regardless of income. in Westchester county, we offer all our employees the same health benefits. We pay the full cost of both individual and family coverage. Under current law we are still required to

---

[1] The National Association of Counties is the only national organization representing county government in the United States through its membership, urban, suburban and rural counties join together to build effective, responsive county government. the goals of the organization are to: improve county government; act as a liaison between the nation's counties and other levels of government; achieve public understanding of the role of counties in the federal system.

pass the complicated nondiscrimination tests. Clearly, this is a waste of valuable staff time and the taxpayers' money.

There are more than enough safeguards in the public sector to protect our employees from discrimination. As elected officials, our policy and practice are always open to public scrutiny. If we exercise poor judgment, our voters don't mind showing their disapproval when we face the ballot box every two to four years.

Counties stand to suffer financially when ever either our employees or residents go uninsured or underinsured. In 31 states, counties are mandated by law to pay the costs of health care for uninsured indigents inside their boundaries. Consequently, there is every incentive for us to offer adequate health care coverage to our employees and encourage other employers to do likewise.

As public employers, counties have historically offered simple and uniform benefit plans to elected, appointed and civil service employees. In most cases our health plans do not remotely resemble those offered by our counterparts in the private sector. In a 1987 report, the Bureau of Labor Statistics found that 94 percent of the full-time employees in state and local governments have medical coverage and 85 percent have life insurance coverage. The report further shows in the majority of cases, that state and local governments pay the full cost for individual coverage. In 27 percent of the cases, it shows that public employers pay the full cost of family coverage; and in an additional 66 percent of the cases, we pay a portion of the cost for family coverage. In light of these facts, Mr. Chairman, we are convinced that the application of Section 89 to state and local governments is unnecessary.

Counties are not only public employers. We provide a full range of vital public services to our residents, including health care, education, law enforcement, fire fighting, courts, maintenance of roads and bridges, and nursing homes. As service providers, we maintain over 1000 health care facilities across the nation, including county hospitals and nursing homes. We spend a significant amount of our revenues each year to provide health care to uninsured indigents. For many of us, this is one of the highest, if not the highest, annual cost for county services. The 1986 bureau of the census report shows that counties spent $14.9 billion on health care services. It also identifies $7.2 billion as uncompensated health care costs for hospital services. While these costs represent the total loss for public and private hospitals, it is safe to assume that the vast majority of these costs were borne by county hospitals since private hospitals usually refer uninsured patients to our hospitals.

We want to commend you and members of the committee for holding this hearing to examine the impact of Section 89 on public and private sector employers. The complicated testing requirements have already forced many counties to hire tax consultants to help sort through an enormous amount of records to determine if we will be able to comply with the nondiscrimination rules. We also commend the sponsors of the Section 89 Simplification Act. In our view, it will offer a reasonable alternative to the complicated testing requirements. We especially appreciate the exemption for local governments and private nonprofit agencies which have no highly compensated employees. Overall, we feel the simplification bill would be a first step in the right direction. However there are a few improvements we would like to see adopted in the bill.

We appreciate the safe harbor created in the bill, which would allow employers to design their health plans to preclude the need for nondiscrimination testing. While this simplified health insurance arrangement might be an attractive alternative, we feel the limits on employee contributions for individual and family coverages are much too low. These levels do not reflect the employer/employee cost sharing that now exists nor the fact that health care costs generally increase much faster than any consumer price index or the minimum wage.

We would also encourage members of the committee to replace the nondiscrimination rules under current law with a more simplified rule. For employers who cannot comply with the simplified health arrangement, a reasonable alternative must be available without the unnecessary data collection and reporting requirements.

In summary, Mr. Chairman, we believe S. 654 would provide an improvement to the existing Section 89 nondiscrimination rules. We believe these improved rules should be applied to areas where broad-based discrimination exists. They should not be applied to public employers who have traditionally offered the same level of benefits to all of their employees and who have safeguards in place to protect against discrimination. To do so, when there is no evidence of discrimination, would be a disservice to our employees and increase costs to our taxpayers. We strongly encourage you and all members to support legislation that will exempt state and local governments from Section 89.

Mr. Chairman, thank you for the opportunity to testify and I would be happy to answer any questions at the appropriate time.

PREPARED STATEMENT OF KARL HANSEN

Thank you, Mr. Chairman, members of the Committee. I am Karl Hansen, an insurance broker who lives and works in Mountain View, California. I am here today representing the National Association of Life Underwriters (NALU). NALU is a federation of state and local associations and represents those associations on matters of importance to them and the 135,000 sales professionals in life and health insurance and other related financial services who are members of those local associations. I am chairman of NALU's Federal Law and Legislation Committee's Task Force on Health Insurance.

As a health insurance broker, I daily work with employers who are providing group health insurance to their employees. My company has more than 300 employer clients, most with employee groups of 50–100 employees. I have had to learn as much as possible about the requirements and purposes of Section 89 in order to advise my clients on how to comply with Section 89's rules, and, where necessary, how to modify their plans so that they are nondiscriminatory as defined in Section 89. Thus, I—and many thousands of my colleagues—have first-hand experience with trying to tailor market-driven group health plans to a set of statutory rules that reflect social, tax policy and revenue needs to a far greater extent than they accommodate the real-world group health insurance market.

Let me begin by expressing my own and NALU's appreciation for your effort to reform Section 89. It is clear that much of the complexity in current law and proposed regulation stems from a laudable effort to be fair, especially with respect to highly-compensated employees of large, diverse businesses. However, it is equally clear that there is an overriding need for a discrimination test that is simple, one that eliminates the need for the burdensome data tracking required by current law's actual coverage-based tests. We believe that your simplified health plan concept as described in S. 654 would solve this need for simplicity. We also very much support the fact that the design-based health plan concept in S. 654 is offered as an alternative to current law, but allows employers to choose to comply with the actual coverage-based tests that are in place under current Section 89 if they cannot take advantage of the simplicity inherent in the design-based test. However, we will offer for your consideration changes to the testing standards that we believe will improve their usefulness to smaller and less complex group health plans, as well as to the larger, more diverse employer groups. In short, with some important modifications, we fully support S. 654.

DOLLAR-AMOUNT AFFORDABILITY STANDARD IS TOO RIGID; PRODUCES UNEVEN IMPACT ON QUALITY OF AVAILABLE COVERAGE

Although NALU supports the concept of the simplified health arrangement as embodied in S. 654, we suggest that the rules would be more suited to the actual marketplace—and just as effective at encouraging broad-based coverage—if the affordability standard were modified. Currently, S. 654 would cap the premium to be paid by a non-highly compensated employee at $6.70/week for employee-only coverage and $13.40/week for the employee and his/her family coverage. Although these amounts are indexed to the minimum wage, they will not automatically adjust to changes in health care costs, and therefore, health insurance premiums. Thus, in addition to the cap as proposed being too low in most instances and in most areas to reflect actual costs and actual employer contributions, it is all too probable that rising costs and therefore premiums will make those dollar amounts even more unmanageably inadequate in the foreseeable future. If inadequate dollar-amount employee contributions drive employer costs unacceptably high, the result could be a serious decline in the level of employer-provided coverage.

Another serious problem with use of dollar amounts pegged to minimum wage as the standard for measuring affordable employee contributions is the fact that geographic and demographic variations around the country will make the impact of the cap fall unevenly on both employers and employees. For example, employers in above-average cost areas are likely to be paying more than minimum wage for jobs that would command only minimum wage in lower-cost areas. Plus, the cost of health care and health insurance is likely to be higher in the high-cost areas. Yet, the uniform $6.70 and $13.40/week caps—even if raised to the more realistic (but still too low for family coverage) $10 and $25/week levels suggested in H.R. 1864—cannot reflect these differences. The result could be lesser-quality plans being of-

A major medical plan that includes a discount for use of participating health care providers (a "PPO" feature), maternity coverage a $100 individual ($300 family) deductible and a 90/10 copayment feature for the first $500 of individual ($1,000 for family) expenses would cost per month about $131 per employee; $243 for employee plus spouse; $248 for employee and child; and $360 for employee, spouse and children. (Please bear in mind that lesser coverage for example, a plan with higher deductibles and/or copayments or fewer benefits would cost less. Conversely, eliminating the "PPO" feature or reducing the deductible or copayment would increase the cost.)

Thus, to meet the discrimination standards set out in S. 654, this employer would have to pay $101.97 for each of its 15 employee-only insureds; $184.94 for each of its 11 employee and spouse people; $301.94 for each of its 18 full family coverages; and $189.94 for each of its 6 employee and child beneficiaries. Thus, this employer is facing a total monthly premium cost of about $10,138.45 if its plan is to meet the discrimination tests set out in S. 654. This compares to $12,635 in total monthly premium for this group. Thus, to be nondiscriminatory, this plan would require the employer to pay about 80% of its cost.

Let's compare this to percentage of compensation and percentage of premium standards. Assume for the sake of argument that an affordable percentage cap would approximate the percentage of the dollar amount cap to the minimum wage. Thus, at $6.70/week for employee coverage on a full-time (40 hour) minimum wage worker ($3.65/hour multiplied by 40 hours, or $7,592/year or $632.66/month), the percentage would be 4.6% of compensation for employee-only coverage. For dependent coverage, a $13.40/week contribution translates into about 9.2% of the full-time minimum wage worker's compensation. A percentage of premium cap should reflect average premium costs as well as typical cost-sharing between employer and employees.

Under the percentage of compensation test the minimum wage workers' maximum contribution would remain at about $29/month for employee coverage and $58/month for dependent coverage. But the other 45 workers could be charged more. Thus, by using a percentage of compensation test, the employer would have the option of reducing the minimum wage worker's contribution by charging more to those who earn more; and, most importantly, would have some room to absorb rate increases due to improved coverage, inflation or a change in employee population that results in more dependent coverage costs. A similar analysis proves that a percentage of premium test could also provide flexibility, especially with respect to multiple dependent rate structures, without sacrificing low-income affordability.

For these reasons we encourage you to offer a choice among dollar amount, percentage of compensation and percentage of premium affordability standards. Such a choice could well produce the incentive to expand coverage rather than shrink it as economic conditions change.

DESIGN-BASED TEST EASES COMPLIANCE BURDEN; BUT FAIRNESS REQUIRES A FLEXIBLE, IF MORE COMPLICATED, ALTERNATIVE

The basis of S. 654—the provision of a "prototype" design-based availability test that is simple to understand and to administer—will alleviate many of the compliance problems inherent in the actual coverage tests that form the basis of current IRC Section 89 and its proposed regulation. The requirement that at least one plan be available and affordable to at least 90% of the employer's non-highly compensated employees is in fact a simple-to-understand, easy-to-administer concept. We support it. We also support S. 654 in that it offers this test as an alternative to the more complicated actual coverage based test concept rather than as the only way an employer's highly compensated employees can receive tax-free group health insurance. Simplicity, for all its merits, also has some disadvantages, chief among them being little room to accommodate flexibility. In addition, the requirement that the core plan(s) be affordable as well as available raises difficult issues that can be fully and fairly resolved only by allowing an employer to choose between the simple design-based test and the more complicated actual coverage test concepts embodied in current IRC Section 89. Although the addition of percentage of compensation and/or premium testing standards help with the flexibility requirement, they do not allow the kind of creative, flexible planning that cost-conscious, larger employers require. The actual coverage tests—the 90/50 test and 75% benefits test are particularly useful for computerized employers with trained benefits personnel and large low-to-medium-wage work forces. It is possible—indeed probable—that current law Section 89's actual coverage tests can be simplified, and to do so would be a worthy accomplishment. But diversity requires flexibility and that, in turn, requires a

fered in high-cost areas, where many of the lower-paid employees could, as a result of comparatively higher wages, afford to contribute more for better quality coverage. Conversely, the employees in lower-cost areas might end up paying comparatively more for similar levels of coverage when geographic and demographic comparison factors are examined.

Any fixed dollar amount cap could have a discriminatory, adverse impact on older employees working for companies with fewer than 15 employees. These small groups are typically fully underwritten; i.e., each plan participant's medical history is examined. The result is that older workers will cost more to cover. This could tend to discourage small businesses from hiring older employees (or any employees with relatively higher health insurance costs) because the employer share of the cost would be higher than if younger, healthier people were hired. Age is not the only potential problem. Potential employees who are more likely to have families—younger women, newly-married people, etc.—are more likely to use maternity benefits. Thus, the dollar amount cap could discourage small employers from offering any maternity coverage, or from hiring people who may seem more likely to be planning families.

In addition, the single cap for "family coverage" cannot accommodate actual availability of different premium rates for different family structures. Many insurers are offering rates pegged to family size. For example, some plans offer one premium for employee plus spouse; another, higher rate for employee plus spouse plus children; and/or still other rates for employee plus children only or employee plus 1, 2 or 3 dependents. Again, the $13.40 cap could produce an uneven effect in terms of the quality of coverage available because of the cost associated with varying family size and structure.

AFFORDABILITY STANDARD SHOULD ALLOW FOR PERCENTAGE OF PREMIUM AND/OR EMPLOYEE COMPENSATION

The addition of an alternative affordability standard tied to percentage of compensation and/or to percentage of premium could solve many of the problems that could arise under a dollar amount cap. Although such a standard would be a bit more complicated than the dollar amounts, it would give employers a choice that could make a difference between offering a plan at all versus one that would be affordable to the employer.

A percentage of the employee's compensation as an affordability standard allows more flexibility in financing without sacrificing much, if any, economic affordability. Further, because wages and prices tend to be related (i.e., high-cost areas tend to be higher-wage areas, too), the percentage of compensation standard would, to a degree, reflect the geographic and demographic variations that produce such an uneven impact on the dollar amount standard. If the test allowed the use of a percentage of premium as well, the problem of multiple rate structures would also be eased.

To illustrate, let's compare a group and how it would fare under several scenarios. Assume, please, a group of 50 employees in my home town, Mountain View, California. The Mountain View area is right in the middle in terms of high versus low cost. The group breaks down as follows:

> 5 employees who are highly compensated; all have a need for dependent coverage. Three need to insure their spouses and children; I will cover only a child and the 5th will insure only a spouse.
>
> 45 non-highly compensated employees, 5 of whom are earning minimum wage (40 hours/week at $3.65/hour, or $7,592/year). Of the 45, only 15 carry employee-only insurance; the remaining 30 need dependent coverage. Ten want spouse-only; 15 cover spouse plus children and 5 insure only one child.

Under the rules proposed in S. 654, the employer would have to make a core health plan available to at least 90% of the 50 employees (45). Since our fictitious group will cover all 50 employees, that test is met easily. Next, to be nondiscriminatory, the employer can charge its 50 employee insureds $6.70/week each, or $29.03/month ($6.70 multiplied by 52 divided by 12). The 35 employees who need dependent coverage can be charged an additional $13.40/week each, or $58.06/month ($13.40 multiplied by 52 divided by 12).

Now let's look at what's available in the marketplace, at what price. First, the most typical employer payment for health insurance is either 50% of the total premium (employee plus dependent coverage), or 100% of the employee premium and a varying portion of the dependent coverage premium. Although there are many variations, a common scenario would be the employer charging the employee 20% of his/her individual premium and 50% of the family coverage premium.

degree of complexity to be fair. This is especially well-illustrated by the problems experienced by cafeteria plans trying to use a simplified health plan test.

Thus, while many—perhaps most—small employers will welcome a safe harbor that embodies the concepts contained in S. 654's simplified health arrangements, the larger, more labor-intensive employers will likely benefit more from the more complicated actual coverage tests. Many have already invested time and money resources in learning current Section 89 requirements and making the plan changes needed to comply. For them, requiring adherence to an admittedly simple but also comparatively rigid design-based test would represent a hardship at least as burdensome as the complicated actual coverage based tests impose on the smaller employers. For this reason we support S. 654 over H.R. 1864.

INCENTIVE TO COVER PART-TIMERS POSSIBLE IN ACTUAL COVERAGE-BASED TESTS

One of the principal motivations behind enactment of Section 89 was a desire to expand employer-provided group health coverage, especially to low-paid and part-time employees. The economics of doing business argue against having to include half-time workers in discrimination testing calculations and for this reason NALU supports easing the part-time rule to 25 hours. However, we also support the provision of incentives to cover more workers. Therefore, we suggest that you consider adding an economic incentive to the actual coverage test part-time hours rules. As they are currently written the rules "count" 17½-30-hour workers as approximately equal value—i.e., the ½-time worker is counted as if he/she received one-half of a full-time worker's benefits. This "conversion factor," if weighted to 2.5 (instead of the current (2) for 17½-hour workers (1.66 instead of 1.3 for 22½-hour workers), could provide an incentive to the employer to actually cover its part-time workers. This is because by doing so the employer could enrich the tax-free coverage it could provide to highly-compensated employees. Such an approach—if not too costly in lost federal revenues—could well turn out to be an efficient, effective way to expand health coverage of low-paid, part-time workers.

DEFINITIONAL MODIFICATIONS ARE NEEDED

For both design-based and actual-coverage-based tests some further definitional modifications are needed. We would like to focus on four specific needs.

First, there remains a real question about how to treat independent contractors for testing purposes. Although it makes sense to treat some independent contractors as if they were leased employees, in many cases the facts are different enough to warrant different treatment. One example is a sales force—like some life insurance agents—that is made up exclusively of independent contractors. Such a group really is not comparable to the in-office employees of the company. Thus, we urge you to create a safe harbor for independent contractors that would allow them to be tested as a separate line of business.

Second, there is now and will be even more in the near future (due to pending accounting practices changes) a real difference in health plans that benefit active employees and COBRA-qualified beneficiaries as compared to retired employees who continue to receive employer-provided health insurance. Thus, we ask you to allow separate testing for former employees who are participating in a retiree health plan.

Third, the pending proposed Section 89 regulation specifies that accidental death and dismemberment (AD&D) benefits are governed by Section 105, and therefore would be subject to Section 89 discrimination rules. However, the typical AD&D benefit—which is a near-universal feature of group health plans—is structured and priced like most Section 79 group term life insurance. Thus, it would be far more appropriate to test for discrimination in AD&D benefits under the discrimination rules of Section 79 rather than the Section 89 requirements. We urge you to specify this in the final Section 89 legislation.

Fourth, it is important to test union employees separately from other employees.

A WORD OF CAUTION: COST COUNTS!

NALU supports your effort to simplify and rationalize the Section 89 antidiscrimination rules but, like you, we are mindful that there may—probably will—be a cost to the reform effort. To date, that cost has not been calculated for any of the reform proposals, nor have there been offered suggestions on how to pay that cost. Until we know the cost, and the source from which it will be paid, NALU's support for any specific Section 89 reform proposal must be contingent on identification of an acceptable financing mechanism.

SUMMARY: IF COST-EFFECTIVE, S. 654, AS MODIFIED, REPRESENTS SIGNIFICANT IMPROVEMENT

To the extent that the cost of Section 89 reform is acceptably financed, NALU supports S. 654, as modified. In other words, we urge you to enact discrimination rules that offer a design-based test as a simple safe harbor, with affordability defined as either a dollar amount cap or a percentage of compensation and/or premium cap. We also encourage you to retain actual coverage based testing for those employers with flexibility needs that outweigh the cost of complying with complex but flexible rules, to accommodate the existence of independent contractor labor forces, to treat collectively-bargained plans separately, and to differentiate between retired employees participating in a retiree health plan from other former employees. AD&D benefits should be tested for discrimination under Section 79 rather than Section 89 provisions.

S. 654 DESERVES SUPPORT, THANKS

In closing, we would like to emphasize how good an effort we think S. 654 represents. It solves many of the problems inherent in current law Section 89 and goes a very long way towards creating workable discrimination rules for employer-provided group health insurance. We thank you Mr. Chairman and members of the Committee for your efforts to date, and for your willingness to consider our input. We will be glad to assist you and your staff in any way we can as this process moves forward. I'll be glad to try to answer any questions you may have.

Thank you.

Enclosure.

THE NATIONAL ASSOCIATION OF LIFE UNDERWRITERS

NALU CALLS FOR SECTION 89 REFORM, SUPPORTS S. 654 WITH SOME MODIFICATIONS

WASHINGTON, D.C., May 9—A spokesman for the National Association of Life Underwriters (NALU) told the Senate Finance Committee today that the nation's life insurance agents fully support efforts to reform Section 89 nondiscrimination rules.

Karl Hansen, an insurance broker from Mountain View, CA, said NALU believes S. 654, a bill offered by Sen. David Pryor (D-AR), represents a significant improvement over current law and "goes a very long way towards creating workable discrimination rules for employer-provided group health insurance."

Hansen is chairman of a NALU task force on health insurance and his company services over 300 employer clients, most with group plans of 5–100 employees.

As Hansen explained to the committee, insurance agents have had considerable "first-hand experience" with the new law, since their clients often ask them for advice on how to comply with Section 89's complicated testing requirements.

Ideally, Hansen said, NALU would like to see a blend of S. 654 and H.R. 1864, the House Section 89 reform bill introduced by Rep. Dan Rostenkowski (D–IL). Hansen urged the committee "to enact discrimination rules that offer as an alternative to current law a design-based test as a sale safe harbor, with affordability defined as either a dollar amount cap or a percentage of compensation and/or premium cap."

Hansen said S. 654's design-based test—which would require employers to offer affordable core health benefits to at least 90 percent of their employees—should be offered as a "safe harbor" alternative to current law. Such a safe harbor would be easier to understand, Hansen noted, but it wouldn't be as flexible as existing law. He said employers should have the choice of complying with current law or using the safe harbor in S. 654.

Hansen also suggested that the dollar-amount affordability standard in S. 654, which is pegged to the minimum wage, may be too rigid. Hansen said rising premiums could make the dollar amounts "unmanageably inadequate in the foreseeable future."

Hansen recommended the legislation include a more flexible "alternative affordability standard tied to percentage of compensation and/or to percentage of premium." He said that such a choice "could well produce the incentive to expand coverage rather than shrink it as economic conditions change."

NALU also supports easing the part-time rule to 25 hours rather than the 17.5 hours required under existing law, but, Hansen said, economic incentives should be added to encourage employers to cover more workers.

Finally, Hansen asked the committee to consider changes clarifying the treatment of independent contractors, retired employees, collective-bargaining employee groups, and accidental death and dismemberment benefits.

The National Association of Life Underwriters (NALU), founded in 1890, is a federation of state and local associations representing over 140,000 sales professionals in life and health insurance and other related financial services.

PREPARED STATEMENT OF SENATOR JOHN HEINZ

Chairman Bentsen, I commend you for holding today's hearing on Section 89—what could be considered the most challenging benefits legislation to come down the road since ERISA. I am familiar with another equally telling description of the Section 89 regulations which pictures these rules as "Congress' attempt to drop an atomic bomb on a suspect anthill—and missed the anthill." Although we can see humor in this description, Section 89, as we all know, is a very serious matter which needs to be resolved quickly to protect employees and employers from it's fall-out.

Mr. Chairman, I would like to express my thanks to you and your staff for selecting such an impressive and diverse group of experts to voice their concerns with Section 89 in it's current form. I anticipate that each of the speakers will be able to shed some light onto this difficult problem. And, I am confident, by the end of the proceedings, my colleagues and I will have a better idea of what additional steps are needed to simplify the current rules.

I would like to take a moment to highlight the rational behind the rules. Mr. Chairman, as you know, currently the federal government is offering enormous tax incentives to make sure our employed citizens have access to health care, through their employer's health plans. Section 89 was created to ensure that our favorable tax treatment of health plans is being used in an equitable manner and that the availability of benefits is not contingent upon the employee's income.

However, Section 89 was a good idea that simply got lost in drafting. Instead of staying with the simple concept the Congress had in 1986, the Conferees on the 1986 Tax Reform Act adopted lengthy rules to ensure that workers actually elected and received health benefits in a non-discriminatory fashion. The concept of a *nondiscriminatory result* in the election of benefits is important, but it is also the father of all the complexity in the Section 89 rules.

The complexity of these rules may be more than an administrative nightmare—it may actually work against our health policy goals of expanding health coverage and restraining the increasing cost of health care. I think it is more than a little bizarre that the tax lawyers have played such a msjor role in rewriting health policy. We might wish for tax purposes that the world of health benefits was simple, but we have to remember that there are a lot of other policy goals we are serving with health benefits than merely paying equitable taxes.

Mr. Chairman, I have heard from many Pennsylvania businesses expressing their frustration and anger caused by the complexity of these regulations. Many people tell me of the thousands and thousands of dollars they are spending trying to comply with the law. They tell me about the long hours they have spent dealing with these eligibility tests—hours they all feel could be much better spent running their business and serving their customers.

A businessman in Carlisle, Pa., who supports the idea that benefits be uniform throughout an organization, writes that the legislation creates an incredible paper burden on American business and will have the effect of reducing, rather than enhancing, benefits for working class Americans. He points out that "it is obvious that those who wrote Section 89 have never managed a business."

I would also like to read an excerpt of a letter I received from the manager of the Township of Upper St. Clair in Pennsylvania who writes, "I believe that while the intent of the regulation may be logical . . . the result . . . is disastrous and the intrusion caused is unacceptable. Quite frankly, it may be cheaper for the Township and the other employers to reduce or eliminate benefits rather than to come into compliance with a one-sided regulation."

Mr. Chairman, we have got to find a workable solution. We can not afford to let business forego providing health and welfare benefits, just because we became over zealous in our efforts to legislate. We need to simplify these rules and to return to the original intent of the law. Senator Pryor and I along with 34 of our colleagues have joined together in developing what we believe has the potential to be that workable solution. Basically, we propose that if an employer offers benefits to 90 percent of the rank-and-file workers and that these benefits are affordable to them, testing is not needed.

I hope that the witnesses today will provide us with constructive suggestions towards improving the Pryor proposal and also comment on the other proposals which have been introduced in both Houses of the Congress. Mr. Chairman, in addition, I want to personally express my willingness to cooperate with you in our mutual efforts to quickly diffuse our so-called "atomic bomb." I would ask that my written statement be submitted for the record.

PREPARED STATEMENT OF MARY KELLEY

Mr. Chairman, on behalf of the more than half million small business owners who are our members, the National Federation of Independent Business (NFIB) is pleased to submit this statement of our members' concerns with Section 89 of the Internal Revenue Code.

At the moment, NFIB's members strongly support the repeal of Section 89. They are concerned that it will negatively affect their ability to expand health insurance coverage to their employees. Growing labor market shortages are pushing small business owners to expand wage and benefit packages in order to attract and keep quality employees, but compliance with Section 89 will divert scarce resources which could be spent on health insurance and other benefits.

Another reason small business owners favor repeal of Section 89 over other solutions is their strong belief that its only real policy objective is the taxation of employee fringe benefits. And NFIB's members have voted overwhelmingly numerous times in opposition to the taxation of employee fringe benefits.

The complexity of Section 89 is not the only objection that small business owners have with the statute. For a discussion of the complexities of Section 89, I would direct the Committee's attention to our testimony submitted to the Senate Small Business Committee on April 13, 1989. But since nearly everyone has conceded the complexity problem, I will focus here on more fundamental objections to Section 89.

Small business owners perceive Section 89 to be fundamentally *unfair* and arbitrary in its treatment of them and their employees. By requiring annual testing, Section 89 assumes that employers are in fact discriminating or are just waiting for a chance to discriminate. Furthermore, the statute defines employers as discriminatory based on actions taken by their employees, i.e. it defines discrimination based on actual participation in benefit plans, not on the availability of such plans. And as if this were not enough, Section 89 leaves employers' and their employees' tax liability uncertain, dependent on the choices of other people, and subject to vast changes retroactively.

Another fundamental objection to Section 89 is its attempt to force employers to consider anyone working more than *17½ hours per week as a full-time employee.* This is objectionable for at least three reasons. First, in many parts of the country insurance companies will not sell health insurance covering employees who work less than 30 hours per week. Second, 30 hours per week is much more in line with the economic realities and working practices of small firms in determining which employees an employer can afford to provide benefits for. And, third, having any threshold less than 30 hours per week would almost certainly cause employers to reduce the part-time work available in their firms.

A third fundamental objection is the definition of *highly-compensated employees.* Section 89, and so far every bill to modify it, defines highly compensated in such a way that *all small business owners would be considered highly compensated.* This is because the definition includes a five percent ownership test. Therefore, whatever his or her actual dollar income, every owner of a small business would be considered highly compensated, even though the average self-employed person in this country makes substantially less than $30,000 annually.

Finally, our members fundamentally object to Section 89 because its only clear cut policy accomplishment will be to begin the taxation of employee fringe benefits. In an effort to increase the tax base by putting limitations on the exclusion from income for employer-provided health insurance, Section 89 has put in jeopardy the very policy goal, i.e. increased health insurance coverage, it seeks to foster. Nothing is accomplished but increasing revenues and aggravation.

The President's *Tax Proposals to the Congress for Fairness, Growth, and Simplicity* (May 1985) includes, in its discussion of the reasons for tax reform, the following:

> For some, it [the current tax system] seems a difficult—and sometimes even *ridiculous*—administrative burden (emphasis added).
>
> Efforts to increase compliance within the framework of the current system seem not only to have reached the point of diminishing returns. They often seem to be *counter-productive:* They *increase resentment and dis-*

respect for a system that cannot long function without a firm foundation of public confidence.

Unfortunately the President's proposal then went on (in Chap 3, part A) to propose complicated and counter-productive non-discrimination rules for employer-provided health insurance and other fringe benefits. Without thoughtful analysis of effects, appropriateness, or costs, the President's proposal became one of the sources of the monster created by Section 89.

Efforts to increase the scope of non-discrimination rules previously applied—rightly or wrongly—to pension plans have gone too far in being applied to other fringe benefits. Such efforts have proved to be truly *counterproductive, beyond the point of diminishing returns,* and have increased resentment and disrespect for the tax system. Besides, health insurance and pensions are completely different products and face utterly different market forces.

It is our members' belief that the voluntary provision of employee health insurance by employers should be held to be in the same category as the President's proposal and Congress place *home mortgages, obligations to Social Security beneficiaries, disabled veterans,* and *charitable contributions:*

> Only a limited number of special deductions and exclusions would be retained [in the tax code] *principally those that are widely used, and generally judged to be central to American values.*

Eighty five percent of the American population is now covered by health insurance—the vast majority provided by employers—up from 40% in 1940. So this exclusion is *widely used,* more widely used than home mortgage interest deduction. Employer-provided health insurance is also certainly judged by the marketplace to be *central to American values.* After paid vacations, it is the most demanded and given fringe benefit in the labor market.

Section 89 purports to be an effort to increase health insurance coverage among the working poor and to eliminate alleged abuse of the tax code by employers who give themselves and their highly-compensated employees better fringe benefits than their non-highly-compensated employees. The first goal, expansion of coverage, certainly will not be accomplished by adding a new hurdle to offering employee health insurance. The second goal, non-discrimination, appears to us to be based on an unfounded assumption of widespread abuse. In fact, the Treasury Department admits there is no evidence of widespread discrimination in the offering of employer-sponsored health insurance. Trying to mandate nondiscrimination is an exercise in diminishing returns which dramatically decreases the chances of reaching the first goal. In short, Section 89 appears to be a solution looking for a problem.

Furthermore, the working poor don't have health insurance for a lot of reasons, but employer discrimination does *not* appear to be one. The competition and mobility in the labor markets of today work powerfully against discrimination. The majority of these employees don't have health insurance because they either choose not to purchase it or because *their employers cannot afford to provide it.* Section 89 only adds to the problem of affordability, and any variation on the current Section 89 will do the same.

As for the alleged problem of excessive benefits for the highly compensated, *where is the evidence?* And wouldn't some form of "facts and circumstances" test be a more flexible, productive manner of trying to get at that which may exist, rather than a "one size fits all" policy? Another approach might be some form of simple certification of non-discrimination on the part of employers or insurance carriers, as suggested by Senator Domenici. Trying to micromanage small business is an expensive mistake.

If Section 89's stated objectives are already, in fact, being accomplished by pre-1986 tax policy and market forces, why are we going through this exercise? We believe it is because tax policy purists object strongly to any form of income escaping taxation. By extension, then, the exclusion from employee income of the value of employer-provided health insurance signals abuse and lost revenue to such people. But there is no law of nature which says taxation's only purpose is revenue collection.

It is useful here to ask why it is that Section 89 calls for the taxation of the value of *employees'* health insurance if their *employer* is found to be discriminating. This is an example of the fundamental unfairness of Section 89, that a second party should suffer tax consequences for the "failures" of another person. But in the context of tax base broadening, of a global definition of income, and of tax policy purity, it becomes clear why employees' fringe benefit income is taxed because of the noncompliance of their employer. *That* was the real objective and goal of Section 89—to tax fringe benefits.

Discrimination is a powerful political smoke screen for assaulting the tax exclusion of fringe benefits. No one wants to be portrayed as supporting discrimination. The underlaying logic of Section 89 is therefore said by some to be *unassailable.*

Of course it is assailable. It is easily assailable to anyone who has the courage to simply think about it. Where is the evidence of discrimination? What is Section 89 doing to health insurance coverage? What other policy goals are being trammeled by non-discrimination rules? What are the costs and consequences of pursuing the logic of Section 89? Is "sameness" the same as "fairness?" Why wasn't the allowable amount of excluded income just capped? Why weren't fringe benefits taxed directly?

Section 89 is misguided tax policy and bad social policy. As Norman Ture, President of the Institute for Research on the Economics of Taxation has said, [Section 89's] repeal would contribute to fairer and more efficient compensation arrangements throughout the economy."

SUBMITTED STATEMENT OF THE NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Before: House Ways & Means Committee

Subject: H.R. 1864

Date: May 2, 1989

Mr. Chairman, on behalf of the more than one half million small business owner members of the National Federation of Independent Business (NFIB), I am pleased to submit this statement of our members concerns with Section 89 of the Internal Revenue Code and our suggestions for modifying H.R. 1864.

Mr. Chairman, NFIB applauds your introduction of H.R. 1864 as a major step toward correcting many of the most troublesome and unmanageable aspects of Section 89. We believe it can be improved in a number of ways.

We also believe it leaves unresolved a number of important health care policy issues, such as, will Section 89 non-discrimination rules in fact increase health insurance coverage among rank and file employees? We are uncertain, but very dubious, at least as it applies to the employees of small businesses, that it will.

At the moment, NFIB's members strongly support the repeal of Section 89. They are concerned that it will negatively affect their ability to expand health insurance coverage to their employees. Growing labor market shortages are pushing small business owners to expand wage and benefit packages in order to attract and keep quality employees, but they are concerned that compliance with Section 89 will divert scarce resources which could be spent on health insurance benefits. They are also concerned that Section 89 will result in a reduction in insurance coverage being offered.

One of the reasons small business owners favor repeal of Section 89 over other solutions is a strong feeling that its only real policy objective is the taxation of fringe benefits. Or even worse, as nothing more than a blatant revenue raising device.

It seems to us that the Congress is on the very sharp horns of a dilemma. H.R. 1864 and constructive modifications of it will be relatively simple but rigid. Being rigid, this solution will, in all likelihood, not be able to accommodate all of the choices in the health insurance marketplace, and will do nothing to increase health insurance coverage among rank and file employees.

On the other hand, the current Section 89, which is relatively flexible, is extremely complex—so complex and so punitive that employers are already dropping health insurance programs.

Unfortunately, neither Section 89 nor H.R. 1864 are effective solutions in the health policy area. From NFIB's perspective it appears that the important public policy objectives of Section 89 are in fact best accomplished by returning to pre-1986 tax law.

With the introduction of H.R. 1864 and the scheduling of these hearings on those in the Senate Finance Committee on May 9, it appears reasonable to believe that Congress is ready to deal with the dilemma created by Section 89. Unfortunately, businesses, especially those on Main Street, across the country are agonizing over confusing and costly decisions revolving around compliance. To eliminate this confusion and preserve scarce resources, we believe that whatever the outcome of this debate, the effective date of current Section 89 should be delayed or suspended at least until the beginning of 1990.

POLICY BACKGROUND AND ISSUES

Section 89 of the IRC was a part of the Tax Reform Act of 1986. The *President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity* (May 1985) discussed the reasons for tax reform. Under the heading of "the system is too complicated" is stated:

> For some [taxpayers], it seems a difficult—and sometimes even *ridiculous*—administrative burden (emphasis added).
>
> Efforts to increase compliance within the framework of the current system seem not only to have reached the point of diminishing returns They often seem to be *counter-productive:* They *increase resentment and disrespect* for a system that cannot long function without a firm foundation of public confidence.

Unfortunately the President then went on (in Chap 3, part A) to propose complicated and counterproductive non-discrimination rules for employer-provided health insurance and other fringe benefits. Without thoughtful analysis of affects, appropriateness, or costs, this proposal became the genesis of the monster created in Section 89.

The heart of the problem lies in proposals that attempt to extend ERISA's nondiscrimination rules to other fringe benefits. Because insurance and pension clans are completely different products, facing entirely different market forces, the application of ERISA rules to both simply doesn't work. In fact Section 89 clearly proves that this attempt was counterproductive.

Providing tax incentives to employers to encourage them to provide health insurance to their employees is an example of public policy that has worked. Eighty five percent (85%) of the American population is now covered by health insurance—most of it provided by employers—up from 40% in 1940. It is a more widely used incentive than the home mortgage interest deduction.

Employer provided health insurance has become a cherished fringe benefit, second only to paid vacations. The tax incentive that has encouraged this expansion of coverage should be viewed at least as "sacrosanct and, to quote President Reagan's proposal further, as "central to American values" as those incentives for home mortgages, disabled veterans, and charitable contributions.

Section 89 purports to be an effort to increase health insurance coverage among the working poor and to eliminate alleged abuse of the tax code by employers who give themselves and their highly-compensated employees better fringe benefits than their non-highly-compensated employees. The first goal, expansion of coverage, certainly will not be accomplished by adding a new hurdle to offering employee health insurance. The second goal appears to us to be based on an unfounded assumption of widespread abuse. Trying to achieve it could be an exercise in diminishing returns, dramatically decreasing the chances of reaching the first.

The working poor don't have health insurance for a lot of reasons, but employer discrimination does *not* appear to be one. The competition and mobility in the for markets of today work powerfully against discrimination. The majority of these employees don't have health insurance because they either choose not to purchase it or because *their employers cannot afford to provide it.* Section 89 only adds to the problem of affordability, and any variation on the current Section 89 will do the same.

As for the alleged problem of excessive benefits for the highly compensated, *where is the evidence?* And wouldn't some form of "facts and circumstances" test be a more flexible, productive manner of trying to get at that which may exist rather than a "one size fits all" policy? Is the next step in tax policy to extend Section 89 nondiscrimination rules to "wages and salaries" in order to "even out" the tax benefits of income?

According to the Joint Committee on Taxation the tax revenues to be raised by Section 89 were to be $72 million in 1988, $128 million in 1989, $140 million in 1990, and $154 million in 1991, or a total of $494 million over four years. The cost of the deduction for health insurance premiums is more than $30 billion: Where is the discrimination? Wouldn't we be raising much larger amounts of revenue if it were widespread and pervasive?

Section 89 is both legislative overkill and a poorly concealed attempt to extend the "comparable worth" theory to tax policy. It is blatant social engineering through the tax code and will only serve to further undermine voluntary compliance.

SMALL BUSINESS EMPLOYEE BENEFITS

Small business employers and enployees are being affected by the rising cost of health insurance premiums and health care in general. Employer-sponsored group

plans are popular because they afford an employee an opportunity to obtain health insurance coverage at a cost that is far lower than he could purchase as an individual.

Unfortunately the small business owner is coming under increasing financial pressure just to maintain current levels of coverage because insurance premiums are increasing 20 to 30 percent or more each year. It is no secret that small plans cannot receive the same benefit of lower cost that some larger employers can because of the economies of scale involved. These cost increases are beginning to affect the types of coverages and options an employer can provide.

The following are some of the relevant results of a major small business employee benefits study done by the NFIB Research and Education Foundation in 1985:

—Paid vacations and health insurance were the two most common employee benefits found among the nation's small businesses.

—The median monthly employer cost of voluntary employee benefits, i.e. benefits not provided by legal compulsion, was $1,450 for those providing at least one benefit. Mean or average monthly costs were twice that pulled upward by a very few firms. Compulsory employee benefits, i.e. legally required benefits such as FICA and workers compensation, cost small business owners about as much as did voluntary benefits.

—The number of small business owners providing employee health insurance has been rising. Sixty-five percent offered health insurance coverage for at least some full time employees, an increase of eight percentage points from a similar survey conducted in 1978. Most responsible for the increase were Financial Service, Professional Service, Retail, and smaller firms.

—Well over 80% of health insurance plans offered in small firms carried an option for dependent coverage.

—The mean monthly health insurance premium paid by small employers was over $1,766, more than double the monthly premiums paid in 1978.

—Small business owners purchased private health insurance from a great variety of carriers. Self insurance (4%) and HMOs (3%) remained an oddity.

—While the firm was the group's sponsor more often than not, trade/business associations have been increasingly assuming that role. Apparently the trend to greater association sponsorship is tied directly to increasing employee health coverage in small firms.

—Nearly two thirds of small business owners with health insurance reported they were generally satisfied with the health care plan offered their employees. That represented a seventeen percentage point drop from 1978 and can be directly related to increased insurance costs.

—Small business owners and/or a designated employee spent comparatively little time searching for health insurance alternatives, health care cost control options, etc. Outside advisors, particularly insurance agents, often substituted for owner/employee search.

—Employee health insurance was not provided by about one third of small business employers. No single reason dominated their decisions. The most frequently cited reasons were: employees generally covered under a spouse or parent policy (secondary wage earners) premiums too high, employee turnover too great, firm insufficiently profitable, and can't qualify for group policies.

The conclusions that we draw from this study are that small firms do not offer more, or any, health insurance for their employers for three primary reasons. First, many small business firms are just too marginal. Second, the kinds of employees that many small businesses hire make it difficult for them to be covered. And third, the nature of the health insurance industry prevents some firms from obtaining or affording coverage.

H.R. 1864

For a large proportion of the small business community, H.R. 1864 is a significant improvement over current Section 89 for at least the following general reasons:

—Compliance will be much less complicated and expensive;
—discrimination is based on availability, rather than on participation;
—employee and employer tax status is much more predictable; and
—the unrealistic definition of part-time work has been improved.

Notwithstanding these significant general improvements, there are a number of specific recommendations we would like to make to H.R. 1864 for its improvement. Furthermore, H.R. 1864 raises some new concerns on its own. In what follows, we have summarized our suggestions and concerns with H.R. 1864:

(1) The change in the threshold at which part-time workers must be considered for purposes of Section 89 testing is certainly an improvement over current Section 89. However, it is our belief that a 30-hour threshold would be more appropriate for two reasons. First, in many parts of the country, insurance companies will not sell health insurance for employees who work less than 30 hours per week. Second, 30 hours per week is much more in line with the economic realities and working practices of small firms. Having any lesser threshold would almost certainly cause employers to simply reduce the part-time work available in their firms to avoid having to count part-time workers in meeting H.R. 1864's 90% availability test.

(2) Tying the new availability test to a 90% rate is too restrictive. This is true especially with a 25-hour threshold for consideration. Ninety percent is also too high because it is not enough leeway to accommodate those individual situations, particularly relevant in small firms, where an insurance carrier may refuse to cover some individual because of a preexisting condition or other underwriting practices. Such situations are beyond the control of the employer, and in a small firm with less than 10 employees, the exclusion of one individual would cause the company to fail the 90% test. The majority of companies in this country employ less than 10 employees. Although not a perfect solution, we would suggest using the same percentage test as exists in testing top heavy pension plans, i.e. 70%.

(3) For maximum employee contribution, using specific dollar figures indexed to average wage growth for maximum employee contributions when the cost of health insurance is increasing so dramatically poses a problem. While the maximum employee contribution figures may be generally reasonable today, they will be totally unrealistic within 2 or 3 years. Furthermore, putting such limits on employee contributions seems to be counter to the need to improve consumer utilization of health care by having them become more aware of the costs involved. In addition, using a uniform dollar level ignores regional differences in wages and insurance costs. *While no solution will solve all of these problems, an improvement would be achieved by either using a cost-based index or by substituting dollar levels with something like a percentage of total compensation.*

(4) By limiting the coverage that a highly-compensated employee may exclude from income to 133% of the value of the employer-provided employee-only coverage that is taken into account in satisfying the 90% test, H.R. 1864 establishes a more stringent requirement than exists in current Section 89. Current Section 89 has a 90%/50% test, H.R. 1864's test is 90%/75%. Requiring in effect a comparison between the lowest-paid employees and the highly-compensated employees will increase the taxable income for highly-compensated employees and probably generate considerable revenues. Another possible reaction is to reduce benefits to the lowest common denominator.

(5) The definition of a highly-compensated employee has not been changed in any way helpful to a small business owner. All owners by definition in this bill are considered highly compensated, even though the average self-employed person makes substantially less than $30,000 annually. It is not clear what public policy goal is being achieved by trying to define all small business owners as highly-compensated individuals.

(6) H.R. 1864 includes the term "qualified core health plan." This term needs to be defined in the law more clearly to prevent the IRS from defining a core health plan in regulations. Citing the COBRA definition would be one such clarification.

(7) The determination of the value of employer-provided benefits should not be left up to the determination of the Secretary of the Treasury. The marketplace determines the value of various types of coverage in the price of premiums or other charges by health insurance carriers. This should be sufficient for all tax purposes.

(8) The leased employee safe harbor created by H.R. 1864 is only of use if a clear definition of "leased employees" exist. At this time no such clear definition exists, therefore the effective date of Section 89 rules as applied to leased employees should be delayed to give the Treasury Department time to development such rules and definitions.

(9) H.R. 1864 requires that if you cover *any* part-time or otherwise excludable employee, then all such employees must be covered and included in the determination of whether or not 90% of the firm's non-highly-compensated employees have benefits available to them. This provision appears as if it will actually reduce coverage. In small firms there are often good and humane reasons for wanting to cover usually excludable employees, for example, an older person working part time. It does not appear as if any public policy purpose is served by requiring the full apparatus of Section 89 to apply in such cases.

(10) Under the bill cafeteria plans would be difficult or impossible to continue. Cafeteria plans are not yet a common feature of small firm compensation packages,

but to the extent that they increase employee choice and possibly better utilization of health care facilities, they are an attractive option. H.R. 1864 appears to preclude that option.

(11) The qualification requirements contained in H.R. 1864 should be more precisely defined at least insofar as what "legally enforceable" and "indefinite period of time" mean. The statute should reflect in the clearest possible way that the employee is only entitled to the benefits the employer has purchased from a insurance carrier or other provider. For small employers an "indefinite period of time" means the end of the billing cycle. This requirement should either be dropped altogether or defined in some reasonably understandable manner.

(12) The 34% excise tax imposed on employers for failing to satisfy the qualification requirements is on "amounts paid or *incurred* during any taxable year *under* a specified employee benefit plan." First, this appears to be a tax based on the amount of benefits paid rather than on premiums paid. This could be a potential disaster for a small business if not clarified to say premiums or their equivalent. Second, the 34% rate is the same as the highest corporate rate. It is not clear why this rate was chosen, especially since there is a graduated corporate income tax rate schedule. In any case, something on the order of a 10% excise tax should be sufficient.

(13) Since small businesses are not heavily unionized, I will not dwell upon the problems H.R. 1864 causes in this regard, other than to say that if union plans and plans provided by the public sector and by tax-exempt organizations are excluded from Section 89 requirements, then there would appear to be much less of a revenue concern with the provision of employer-sponsored health insurance plans. Indeed, excluding such plans would argue that Section 89 is primarily targeted toward small businesses.

CONCLUSION

H.R. 1864 is a significant improvement of current Section 89. It is dramatically less complex and much easier for small business owners to understand and comply with. It can be improved further, though and NFIB strongly urges the Committee to consider the serious problems we have outlined, especially the dollar figures and index used in the eligibility test and the treatment of part-time employees. A simpler, more workable approach is still possible.

Even though H.R. 1864 is a better solution than current Section 89 and can be improved further, we remain skeptical that it does anything to improve or extend coverage of health care. It will still be a new impediment and disincentive to employers, especially smaller employers, to provide health insurance. Therefore, it will reduce, if only marginally, the current government incentive in this area.

If this analysis is accurate, then both Section 89 and H.R. 1864 are little more than cleverly manufactured methods to tax employee fringe benefits. The conclusion becomes even stronger that the evidence used to prove discrimination is little more than anecdotal in nature.

H.R. 1864 may be a major improvement, especially in the areas of complexity and compliance, for most small business owners, but it will be a step backward in our efforts to expand employer-provided health insurance. It also breaks significant new ground in the taxation of employee fringe benefits. Therefore, NFIB continues to prefer and support the repeal of Section 89.

As this issue has been analyzed and debated, a number of individuals—including Senator Heinz, a major voice on health care issues in the Senate—have suggested that discrimination problems in the health insurance area, if they exist, can be taken care of by a simple statement or declaration by employers that they do not willfully or to their knowledge discriminate in providing this fringe benefit. Given the documentation problems with Section 89 and the potential negative effects of H.R. 1864, it may be well worthwhile for the Committee to pursue this approach.

Mr. Chairman, the introduction of your bill and these hearings are a strong signal that current Section 89 will be significantly changed. While you and your colleagues debate the final outcome of Section 89, something must be done to ease the frustration of Main Street and prevent the needless waste of scarce resources on needless compliance. NFIB urges you to join with Senator Bentsen and Secretary Brady to find some way to suspend enforcement of the current law until the changes you will enact can be put in place.

ADDENDUM

SMALL BUSINESS REACTIONS TO SECTION 89

Health Care Professional—Mt. Vernon, Washington:

"I appears that we are headed in the direction of mandatory insurance coverage by employers and that Code 89 is directed toward that means."

Heating & Cooling Company—Cookeville, Tennessee:

"The additional paperwork to assure compliance will increase my overhead costs thousands of dollars each year. Will this Section 89 benefit my employees? The answer is NO! The additional expense will cost my company business in the marketplace."

Insurance Agent—Vincennes, Indiana:

"The 'actual' effects of this Section 89 law are totally opposite of those envisioned by the Congress and is eliminating health insurance coverage for millions of Americans who have enjoyed group health insurance provided by their employers in the past."

President, Construction Company—Sioux Falls, South Dakota:

"I would rather have a 1% increase in income tax rate than risk complying with Section 89. Because Section 89 is really a tax increase in disguise."

President, Express Company—Fort Atkinson, Wisconsin:

"As a result of a Section 89 seminar, I have decided not to pursue instituting a pension plan for our employees at this time. We are a small company employing 16 people. I just do not feel that we can afford the legal expense and potential risk from the uncertainties of this new legislation."

President, Electronics Company—Cornelius, Oregon:

"Section 89 rules are so complex that even our small business of thirty people is looking at $800.00 in wasted expenses every year just to see if we comply. Mind you this money doesn't benefit either the employee or employer."

President & CEO, Construction Company—Jacksonville, NC:

"Our company currently has in place, incentive programs for those key 20 employees on the form of pension and medical plans. The cost of these programs has been incorporated into our bid process through overhead factors. Enter Section 89. If we decide to maintain our existing program on a non-discriminatory basis our cost jumps from $15,000 per year to over $100,000 per year. Option No. 2 is maintain existing plans on a discriminatory basis and pay the price for consulting and compliance. This cost for employers our size is estimated to begin at $10,000 annually. Add to this, additional payroll tax on grossed-up wages, and our overhead factor increase becomes visible. Option No. 3, and our best option, is to scrap all programs, blame the decision on Section 89, gain a temporary edge on our competition, and keep our key people employed.

"Through implementation of so-called 'socially equitable' programs such as section 89, our government has stepped in and begun eroding sound and fair business management philosophies and is slowly destroying the entrepreneurial spirit."

Insurance Agent—West Palm Beach, Florida:

"Many of may accounts are contemplating dropping their group plans in favor of letting each employee buy his own individual policy."

"All the plans, and I mean all the plans, sold to 99% of all purchasers of group insurance contain the same level of benefits to all classes of employees. I have about 100 clients and all of my cases have the same benefit structure for all classes of employees. So what I am saying is that I and my employers know our plans do no discriminate in favor of highly compensated employees, because everyone has one level of benefit."

President, Advertising & Public Relations—Cheyenne, WY:

"I have been considering offering my employees health insurance. Since trying to 'figure out' what the so-called non-discrimination rules are, and the fact that the IRS has not issued regulations on how to comply, I have simply given up the idea."

Owner, Art Supply Company—New Albany, Indiana:

"If Section 89 is not repealed, and/or if fringe benefits are taxed, we will be faced with only one just alternative to offering this program; to raise my employees wages up to include the additional we now pay in insurance benefits, and to let them shop for their own coverage."

President, International Business Transportation Services— Kansas City, Missouri:

"Due to Section 89 our corporate attorney and accountant advises me that it will cost my firm approximately $3-4,000.00 per year to retain a company benefits consultant firm to test and submit compliance reports to the federal government? The existence of Section 89 will leave us with no alternative but to eliminate or greatly reduce our overall benefits, retirement plan, life and medical insurance benefits in order to simplify and afford to meet the administrative compliance nightmare for my firm."

Responses by Mary Kelley to Questions From Senator Pryor

The Section 89 Simplification Act, S. 654 Section by Section Anlysis

Section 2.—Establishment of simplified health arrangements a new Section 90 of the IRC.

A plan that qualifies as a simplified health arrangement will be exempt from the testing requirements of section 89. A plan will qualify for this treatment if:

(1) the plan meets current section 89(k) qualification tests;

(2) (a) 90% of all employees are eligible to participate in the plan, and

(b) all plans of the same type have the same employer-provided benefit; and

(3) the cost to an employee for employee-only coverage cannot exceed $6.70/week or $13.40/week for dependent coverage. These levels indexed to minimum wage increases.

Comment

This approach begins to acknowledge that "availability," not "participation," is the standard an employer should be held to. However, the maximum employee contribution levels are unrealistically low, especially for dependent coverage. Indexing the levels to minimum wage increases ensures that they will become even more unrealistic. Fixing employee contribution levels into the law and requiring the same employer-provided benefit does not allow for strategies to improve health care utilization.

The bill makes a slight movement in the right direction as written. An effective "safe harbor" would help get some employers out from under Section 89, but would also be bad health care policy.

A better, more workable idea might be to replace Section 89 entirely with a simple requirement that a qualified health plan not preclude low-paid workers from participating, and that all plans be available to all, or nearly all, of the full time workers.

Section 3.—Treatment of part-time employees.

The definition of a part-time employee would change under Section 89. The new schedule would replace the current section 89 standard of 17½ hours as the threshold for exclusion, as follows:

1989—30 hours per week
1990—27½ hours per week
1991, and after—25 hours per week

Comment

Part-time workers are disproportionately employed by small firms. While the proportion of part-time workers and typical time worked varies by industry and region of the country, using 17½ hours per week as the threshold to be treated like a full-time worker is completely unrealistic for small firms. Any threshold very likely will decrease the hours a part-time worker is able to work. Furthermore, in many areas of the country you *cannot now buy* insurance for part timers working less than 30 hours per week.

The proposal is certainly an improvement, although 30 hours per week would be preferable as the final threshold if part timers must be included with full-time employees at all. Part timers *are* different for an employer than full-time employees, therefore it is legitimate and appropriate that they be treated differently for benefits.

Section 4.—Simplifications and Clarifications of Section 89.

(A) Penalties that might be assessed for failure of a plan to meet the qualification tests would only be assessed against highly-compensated employees as opposed to all employees.

Comment

This is a marginal improvement, but it fails to address problems with the qualification tests themselves, e.g., the definitions of notification, legally enforceable, and permanence. It also penalizes some employees for actions outside their control and does so retrospectively. Section 89 and this modification seem to be predicated on the belief that there is a class conspiracy of the highly compensated against the less than highly compensated and that, therefore, everyone in the class of highly compensated employees should bear the responsibilities for the decisions of a few of them.

(B) The value of the benefits assessed for a failure to meet the qualification tests would be the full value of the insurance coverage or the COBRA cost as opposed to the value of insurance benefits received.

Comment

If this means premiums, then it is an improvement. The Section 89 language of including all benefits received in income will cause untold injustices unless changed in this direction.

(C) Section 89 nondiscrimination testing will not apply if there are no "highly-compensated" employees The change removes the requirement that in the absence of a "highly-compensated" employee, otherwise defined, the highest paid employee will be deemed a "highly-compensated" employee.

Comment

By failing to change the definition of "highly-compensated" employee, this probably only helps public organizations and non-profit organizations. The definition of "highly compensated" in Section 89 is so inclusive concerning ownership percentages (5% makes one an owner) that typical small business owners making less than $30,000 a year are considered "highly compensated". This is, therefore, another very marginal improvement.

(D) The so-called one time a year testing rule of Section 89 would be modified so that if a "highly compensated" employee changes coverage during a year, additional testing will not be required.

Comment

Under Section 89 almost any life event of a "highly-compensated" employee would trigger a new round of testing and data collection for employer plans. Therefore this proposal is a good one.

(E) Deemed coverage rule—If under an employer- sponsored plan 80% of the non-highly-compensated employees benefit from employee-only coverage, and if all these employees are able to elect dependent coverage on the same basis as a "highly-compensated" employee, and if the maximum non-highly-compensated employee contribution for dependent coverage does not exceed $13.40 per week, then the dependent coverage would be deemed to satisfy the 80% benefits test of Section 89 and no further testing would be required.

Comment

This would be a simplification if anyone qualified. The limitation on employee contribution makes it unlikely that many plans would qualify. Furthermore, it is built upon the 80% participation test for employee-only coverage when a fairer test would be based on availability from beginning to end.

(F) Aggregation rule—Under Section 89 two plans are comparable and can therefore be aggregated for testing purposes if the difference in costs for "highly-compensated" and non-highly-compensated employees is no more than $100 per year ($8.34 per month). The proposal here is to change this to $365 per year ($30.42 per month).

Comment

Probably of minor positive affect now and of even less use in the years ahead.

(G) Valuation of Coverage—Under present law, a transition rule allows an employer to value coverage by a "reasonable method", specifically mentioning using the employer's premium cost. This proposal is to make the transition rule permanent.

Comment

A good simplification.

CONCLUSION

Section 4 (simplification) only begins to approach needed reforms. It makes minor changes around the edges of Section 89 without addressing any of its underlying substantive problems. It also falls short of solving the law's complex compliance nightmare and the onerous manner in which penalties are imposed retroactively.

PREPARED STATEMENT OF REP. JOHN J. LAFALCE

Mr. Chairman, thank you very much for affording me the opportunity to appear before your Committee today.

Before moving to the substantive points I'd like to make, let me first reiterate my pleasure that you, Mr. Chairman, and several other Senators have shown an interest in trying to solve the problems which have arisen as American employers have tried to cope with Section 89 of the tax code.

As you may know, I introduced a bill to repeal Section 89 in the House of Representatives in January. As of now, that bill has 302 co-sponsors, approximately half Democrats and half Republicans. This overwhelming show of bipartisan support for repeal of Section 89 demonstrates, I believe, that the American people have seen what Congress produced and they have found it wanting.

My bill was based on concern that, as presently written, Section 89 was likely to have a seriously counter-productive effect. As Chairman of the Committee on Small Business, I had, of course, heard from many individual businesses and their representatives here in Washington about the burdens of compliance with Section 89. And some of the most distressing news I heard was that many such employers were seriously considering dropping any health insurance plans at all, in lieu of trying to meet the tests in Section 89 and risking the penalties if they didn't meet the guidelines.

This told me that there was a substantial likelihood that Section 89 would backfire—that in the final analysis it would result in fewer Americans having access to employer-sponsored health insurance, rather than more.

As I looked further into the issue, I learned that this problem was hardly limited to small businesses. Indeed, all employers in the U.S. were affected. Every level of government, every school board, every college and university, non-profit organizations, labor unions, you name it. Each one had to collect voluminous data and prove, year in and year out, that their health insurance plans were not discriminatory. Providing that proof would not be easy or inexpensive.

The Committee on Small Business held hearings on this issue earlier this year. Some of the experts who testified at those hearings said that the total annual cost of complying with Section 89 as presently written could come to billions of dollars.

Importantly, little if any of these expenditures will strengthen our economy or increase our productivity. And in my view the likely costs of Section 89 are too high a price to pay for a problem which is, I believe, probably quite limited in scope. Surely we should seek a more efficient way of addressing this issue.

Repeal of Section 89, in my judgment, would have a positive impact both for employers and for the U.S. Treasury. Rather than spending time, talent and money on meeting the detailed and arcane rules for compliance, employers would be doing more productive things and the whole economy would be enhanced.

During my study of Section 89 I have tried to learn how serious a discrimination problem we had in the provision of health insurance benefits. And frankly, Mr. Chairman, I didn't find much of a problem at all. It appeared to me that this important benefit was being provided in reasonably equitable ways by most employers, and that the trend was toward greater coverage as competition for workers led more and more employers to provide health insurance.

In other words, it appeared to me that the apparatus we had established to deal with discrimination in the provision of health insurance coverage was costing far more than would be justified by the degree of discrimination it was addressing. Put bluntly, the solution was worse than the problem itself.

Probably the cleanest way of addressing this issue is the one which was the genesis of Section 89 in the first place—the provision in President Reagan's first set of tax reform proposals in 1984 to tax all fringe benefits above a minimum level. This would not have required discrimination tests, differentiation between classes of employees, qualification rules, judgments about affordability, or voluminous record-keeping by employers.

Maybe we should revisit that approach, Mr. Chairman, for it is clear that Section 89 as enacted in 1986 didn't work, and the technical corrections made last year didn't improve it enough.

Others believe that we can address the problem by excising the existing Section 89 and replacing it with a new program. This is the approach encompassed in Chairman Rostenkowski's bill, and I consider it to be a major positive step toward providing much-needed relief for American employers. I am working with Mr. Rostenkowski and the Ways and Means Committee to address some of the issues raised by his bill, and I hope that the effort on which we are embarked will result in a substantially streamlined program which is truly workable in the real world.

I have appended a copy of remarks I made to the Ways and Means Committee last week to my written statement today, in order to share with you my thoughts on the approach embodied in Chairman Rostenkowski's bill.

As you address this issue, I would encourage you to keep in mind that millions of employers are out there wondering whether they should continue trying to meet the requirements of the existing law, or whether they should gear up to meet a different set of requirements based on bills introduced in the House or in the Senate, or just what they should do. The Administration's delay in the implementation schedule for Section 89 from July to October is welcome on this front, but for as important a fringe benefit as health insurance, most employers have to look quite a bit further ahead than just a few months. I would hope that while final action is pending we could find a way to put the entire issue on "hold" so employers wouldn't have to try to guess which route is the safest and fear that they might guess wrong.

There is one thing that this whole episode has brought home to me, Mr. Chairman. And that is that *Congress ought to be leery of trying to solve every hypothetical hazard or potential abuse if, in doing so, we bring about pain or confusion for the vast majority.* Should serious *actual* abuses come to light in the future, we can always address them at that time.

In conclusion, I appeal to this Committee to listen to the pleas of American employers of all kinds for relief from this bureaucratic nightmare. Like you, Mr. Chairman, I think that Congress and the Administration should face facts with regard to the fiscal mess we find ourselves in. Section 89 may be a medium-sized example of how we can get entangled in a situation and have serious problems extricating ourselves because of its budgetary impact. Let's acknowledge that Section 89 was a mistake which cannot be fixed by mere tinkering. The law now on the books must be repealed, de facto if not de jure. If we must address the issue of discrimination, a vastly simpler and less burdensome way to do so must be found. This is what the American people are demanding and what they deserve from us in the Congress.

The United States faces many challenges as we head into the 21st Century. Not least is our ability to continue to compete in the world economy. Our ability to do that is diluted when we ask employers to spend their precious time and money on unneeded bureaucratic tasks.

Mr. Chairman, thank you again for the chance to appear before you today. I would be pleased to respond to any questions you might have.

Enclosure.

REMARKS OF REP. JOHN J. LAFALCE, CHAIRMAN COMMITTEE ON SMALL BUSINESS, U.S. HOUSE OF REPRESENTATIVES, BEFORE THE COMMITTEE ON WAYS AND MEANS, MAY 2, 1989

Mr. Chairman, thank you very much for affording me the opportunity to appear before your Committee today.

Before moving to the substantive points I'd like to make, let me first reiterate my pleasure that you, Mr. Chairman, Majority Leader Foley, and several members of this Committee have introduced legislation which, as you said when introducing H.R. 1864, "completely replaces existing Section 89" of the tax code with a new, substantially simplified program. I hope that a final product which does that and responds to the concerns raised about H.R. 1864 can be achieved, since the only alternative would be complete repeal.

As I understand it, the introduction of non-discrimination guidelines in the area of health insurance was intended to do two things: ensure that favorable tax treat-

ment not be provided to sustain unreasonably higher levels of benefits for the highly compensated, and to provide incentives to encourage health insurance coverage for a greater number of American workers particularly those at the lower end of the economic scale. Effective incentives to accomplish that end will help bring down the number of Americans not now covered by health insurance—a staggering 37 million people, half of them workers and half of that number employees of smaller businesses.

The bill I introduced in January to repeal Section 89 was based on my view that, as presently written, it was likely to have a seriously counter-productive effect. As Chairman of the Committee on Small Business, I had, of course, heard from many individual businesses and their representatives here in Washington about the burdens of compliance with Section 89. And some of the most distressing news I heard was that many such employers were seriously considering dropping any health insurance plans at all, in lieu of trying to meet the tests in Section 89 and risking the penalties if they didn't meet the guidelines.

This told me that there was a substantial likelihood that Section 89 would backfire—that in the final analysis it would result in fewer Americans having access to employer-sponsored health insurance, rather than more.

As I looked further into the issue, I learned that this problem was hardly limited to small businesses. Indeed, all employers in the U.S. were affected. Every level of government, every school board, every college and university, non-profit organizations, labor unions, you name it. Each one had to collect voluminous data and prove, year in and year out, that their health insurance plans were not discriminatory. Providing that proof would not be easy or inexpensive.

The Committee on Small Business held hearings on this issue earlier this year. Some of the experts who testified at those hearings said that the total annual cost of complying with Section 89 as presently written could come to billions of dollars.

Importantly, little if any of these expenditures will strengthen our economy or increase our productivity. And in my view the likely costs of Section 89 are too high a price to pay for a problem which is, I believe, probably quite limited in scope. Surely we should seek a more efficient way of addressing this issue. The fact that nearly 300 of our colleagues have co- sponsored H.R. 634, my bill to repeal Section 89, tells me that there was and is a large number of Americans who concur with this conclusion. And Mr. Chairman, your bill provides the potential framework for just such an approach.

Before proceeding, I would like to put in a plug for another bill I introduced as a companion to H.R. 634. This bill deals with discrimination regarding the tax treatment of health insurance benefits as well.

What I'm speaking about here is discrimination by the United States of America against one unique group of citizens—self- employed individuals who, for whatever reasons, have not seen fit to incorporate. While corporations can deduct 100% of the employer-paid health insurance premiums (presuming they meet Section 89 requirements), including those pertaining to owners of the business, unincorporated enterprises are treated differently. Prior to 1987, no health insurance premiums paid on behalf of owners of this form of business were deductible as a business expense. The Tax Reform Act of 1986 changed this; at present, 25 percent of such premiums qualify as a business expense.

And this does not affect business owners alone. Rather, the existence of this distinction between incorporated and unincorporated businesses has been, as my friend and colleague Pete Stark said when he introduced similar legislation last year, "a significant disincentive to the provision of health insurance" to all employees in these businesses—employers and employees.

I recommend that this Committee move forward on this issue as soon as possible. Surely we should start the process of ending the discrimination we created simply by differentiating on the basis of the legal character of a business. We could accomplish this by providing 100 percent deductibility in one step or, as has been proposed, we could phase it in by increasing deductibility from 25 to 50 percent this year, 75 percent next year and then 100 percent in 1991.

Mr. Chairman, I do not want to devote my time here today getting involved in a highly detailed discussion of your bill's provisions. Other witnesses no doubt will do that. Rather, if I may, I would like to discuss one issue in some depth and then just briefly note those areas where, I believe, some refinement might be considered, and leave the detailed analysis to others with more expertise than I.

Employee Contribution Limits and Indexing.—The issue I would like to discuss at some length is one which impacts each and every employer and employee and which, I believe, can be made more equitable than is the case in H.R. 1864 as presently written. I refer here to the employee contribution limits of $10 per week for

individual health coverage and $25 per week for family coverage, along with a proposal to tie these limits to changes in the wage-based inflation index.

I have two problems with this provision. First, it ignores regional differences in both pay and medical costs. Equivalent health plans might cost $100 per month in one area and $150 in another. And comparable employees in those areas might earn $20,000 in the first instance and $30,000 in the second. As drafted, the proposed new Section 89 could result in each employee contributing $10 per month, thus penalizing the lower paid employee (in a relative sense) and, similarly, penalizing the employer in the area with the higher health insurance costs.

Second, indexing the limits to the wage element of the CPI will have the effect of building in a continual increase in the employer's share, if present trends prevail. Inflation in health care costs, and health insurance premiums, has been substantially higher than inflation as a whole. As this cost of doing business rises, American employers may become less competitive or, in the alternative, will find it necessary to scale back the health insurance programs which they offer to their employees.

One idea would be to put a limit on the percentage of the health insurance premium to be paid by the employee. This would eliminate regional disparity and the need for an index, but we would have to wrestle with questions regarding deductibles and co-payments under various plans, to say nothing of trying to figure out how to apply such a test in instances where an employer self-insures.

Another suggestion for dealing with this problem is to make the contribution limit a percentage of the employee's income. This, too, would relieve regional inequity and eliminate any need for indexation. And since deductibles, co-payments and self- insurance would not loom as large using this approach, it may be the most appropriate way of solving the problem.

In any event, I would urge the Committee to move away from the dollar limit and the index, if possible, and devise another way of ensuring that lower-income workers can have reasonably equal access to this very important benefit.

As I said before, there are some other areas which may warrant further consideration. I will simply run down the list and let the experts provide you with the details on why a problem exists and how it might be addressed.

Definition of Part-Time Employee.—Historically, a 30-hour week has been traditional as the dividing line between "full- time" and "part-time" workers. I recommend that the Committee consider this in lieu of the 25 hour standard in the bill.

Eligibility Criterion.—Some feel that the requirement that 90% of the rank and file be eligible for a plan establishes a very steep cliff. The point is made that this is particularly difficult for the smallest employers. I would suggest that the Committee consider using the 70% standard which, I understand, is used in the pension area. Alternatively, a sliding scale depending on the size of the employer might be appropriate.

Cafeteria Plans.—An irony here is that a number of so-called "Cafeteria Plans" which qualify under the present Section 89 would not qualify under H.R. 1864. I would hope that the Committee would seek ways to eliminate this anomaly.

Benefits Test.—As I understand it, the 133 percent test in H.R. 1864 differs from the comparable test in the existing Section 89 in that it compares the lowest level of benefits received by an individual employee in the non-highly compensated category against the highly compensated employees, whereas the present Section 89 compares the average of those in the non-highly compensated group against the highly compensated group. Perhaps we should consider keeping the average as the testing benchmark. Incidentally, I would also ask that you make it clear that the test be based on the insurance premiums, whether or not you follow my suggestion concerning elimination of the valuation process.

Qualification Tests.—A primary concern here is that Congress should make sure that the IRS understands that we want reasonableness to govern in their interpretation of these standards, for many do not trust the IRS to act reasonably on a matter of this kind without specific exhortation.

This is particularly important in light of the penalty for non-compliance: the 34 percent excise tax. Indeed, Mr. Chairman, I would join those who recommend that you consider lowering the penalty. My purpose here would be to avert instances where an employer might decide to eliminate benefits to all employees due to fear of inadvertent non-compliance with the qualification tests and the financial consequences of such an event. Related to this, I believe it imperative that the legislation make clear that any excise tax would be applied based only on employer-paid premiums and not on benefits received by employees.

Multi-Employer Plans.—Employers who contribute to multi-employer plans are concerned that their ability to assure that a plan qualifies and is non-discriminatory is seriously limited. These employers, who are concentrated in the construction in-

dustry, make cash contributions to the plans' trustees but have little if anything to say about the plan and its administration. Data collection would be very difficult since employees come and go so frequently. Somehow we should try to deal with these legitimate problems and concerns while guarding against potential abuses. *But in this area as in others, Mr. Chairman, I don't think we should try to solve every single hypothetical hazard if, in doing so, we bring about pain or confusion for the vast majority.* Should serious abuses come to light in the future, we can always address them at that time.

Effective Date.—I believe there is a substantial likelihood that Congress will enact major changes to replace Section 89 this year. But it is also possible that final action may not be reached in the near term. In these circumstances I have two recommendations: that we include a provision in the bill making those changes effective on January 1, 1990, and that we relieve employers' burdens during the balance of 1989 by working with the Bush Administration to seek action which would effectively, and immediately, defer any present necessity to comply with existing Section 89.

In addition to these, I would encourage you to devote some attention to other areas of concern including: definition of a qualified core health plan, the problems of defining and dealing with leased employees and independent contractors, valuation of benefits, excludable employees, and collectively bargained plans.

Mr. Chairman, this may seem to be a long laundry list, but I think that there is merit to the concerns that have been raised about all these issues and I would urge you to give careful consideration to the testimony of others which will, I have no doubt, provide detailed analysis as well as potential solutions to the various problems.

The United States faces many challenges as we head into the 21st Century. Not least is our ability to continue to compete in the world economy.

Free enterprise is the cornerstone on which our economic system is built. You and your colleagues on this Committee, Mr. Chairman, have been leaders in the effort to simplify our tax laws and in the process enable individuals, businesses, and other elements of our economy to spend their time doing productive, useful tasks. I believe that H.R. 1864 can become an appropriate vehicle through which we can pursue that same philosophy with regard to Section 89 and the serious complications it has engendered. With appropriate modifications as outlined in this statement, I will be pleased to continue working with you toward bringing this to a rapid and satisfactory conclusion.

Mr. Chairman and my colleagues, thank you again for the chance to appear before you today. I would be pleased to respond to any questions you might have.

PREPARED STATEMENT OF JAMES H. LAGOS

Mr. Chairman and Members of the Committee: I wish to express my appreciation and the appreciation of the 50,000 small businesses represented by National Small Business United to you for holding these hearings. You are giving us the opportunity to testify as to the effects of one of the most ill-conceived and devastating tax laws to come out of Congress in recent years.

As you may well know, National Small Business United is the oldest association exclusively serving the small business community of our nation—for over 50 years now. NSBU has a membership of over 50,000 individual companies with members in each of the 50 states, as well as local, state, and regional organizations. It is our desire to work constructively to shape a bill reforming Section 89 of the Internal Revenue Code that will be workable and with which we can all live.

Section 89 was first designed to address the "problem" of discrimination in employer-based fringe benefit plans. Its goal, stated since by its proponents, was to extend health and life insurance coverage under these plans to all employees (or, to more employees). Section 89 will result in accomplishing exactly the opposite; in fact, many benefits will likely be terminated.

The problems with Section 89 are manifold. The bookkeeping requirements are extremely complex and burdensome. If the Regulatory Flexibility Act applied to Congress, this legislation never would have become law. The employer's first step is to satisfy the qualification rules. These rules demand that the employer's health and life insurance plans: (1) are in writing; (2) guarantee that employee's rights are legally enforceable; (3) notify employees of benefits available under the plan; (4) exclusively benefit employees; and (5) must be intended to be permanent.

Once the qualification rules are deciphered and met, the employer is just beginning to comply. Before the employer can begin to test benefit plans for compliance, more data gathering is required; the employer must:

- Identify the company's total number of plans
- Determine each plan's value
- Identify the employees actually participating in each plan, and
- Determine whether employees are classified as highly compensated or non-highly compensated.

Section 89 defines a benefit "plan" very narrowly. Under Section 89, each separate provision or benefit is considered a plan, and varying levels of coverage within the same plan types are considered to be separate plans. For instance, if a business which offers a fairly simple and straight-forward plan having a base health plan, a dental plan, and an HMO option has a layered structure for these plans: employee only, employee and spouse, and family options, then the business is considered to have nine different plans. Each one of those plans must meet a whole battery of tests—ones just described and ones to follow—and valuations and determinations must be made with respect to each and every employee.

Now, Section 89 gets even more complex. Employers must take their gathered data and apply it to eligibility and discrimination tests. Depending upon plan complexity and availability, employers can use one of two tests; one is the somewhat less complicated 80 percent alternative test and the other is a four-part test. It consists of (1) the 75 percent benefits test, (2) the 90–50 percent availability test, (3) the 50 percent availability test, and (4) the nondiscriminatory provision. Suffice it to say these tests are rather intricate. Once employers have reached this point, once they have stated their benefits policy, determined the number of offered plans, figured the value of these plans on a per-employee basis, decided which employees do and do not qualify as highly compensated, and, based upon those determinations, run the discriminations test, they can then determine whether or not they comply with Section 89. If they comply, nothing changes in their lives; if they do not, they may face major financial consequences on top of the regulatory nightmare they have just spent so much time and money to conquer.

Anyone who believes that small businesses can plausibly meet these requirements, given their time, accounting staff, legal knowledge, and general resources, has very serious misunderstandings about how they function.

Most small enterprises will be forced to bring in outside consultants to evaluate their insurance plans and determine whether those plans comply with Section 89. The costs of these consultations usually run at least several thousand dollars per test—even for small businesses with simple plans. Once this evaluation is completed, there is another charge for coming into compliance and the high cost of changing and up-grading plans to meet the government requirements.

In order to avoid this scenario employers will often terminate their plans, thereby cutting out the cost of consultation, data collection, and compliance. Section 89 contains every incentive for employers to end their health coverage. Terminated benefits is the logical extension of this very bad legislation.

In the Congress, bills have been proposed to reform Section 89. NSBU sincerely thanks the Senators and Congressmen who have sponsored this legislation for taking an active interest in this issue and for working in good faith to try and work-out a solution. Their time and effort are very much appreciated. The reform effort is a strong start in the right direction. We should note that some aspects of the reform bills have not yet gone far enough, but it is our desire to work with Congress and the Committee to shape a bill which will finally be workable and acceptable. Let me take a moment to comment specifically upon S. 654 and H.R. 1864.

S. 654 first proposes the establishment of a simplified health arrangement (that is, a "safe harbor" under which compliance would be greatly simplified). Under this plan, employers are not required to perform the non-discrimination tests if their health plan (assuming there is only one) is available to at least 90 percent of their employees. Also, this proposal indirectly establishes a minimum standard of benefits by imposing $6.70 per week (five percent of the minimum wage) as the maximum employee contribution to a health plan and $13.40 per week as the maximum contribution for dependent coverage. These absolute dollar amounts are indexed to increases in the minimum wage.

H.R. 1864 has been proposed by Chairman Rostenkowski in the House. As currently written, H.R. 1864 requires that employers offer core health insurance to at least 90 percent of their non-highly compensated employees at an employee cost of no more than 10 dollars per week for individual coverage and 25 dollars per week for dependent coverage. These fixed-dollar amounts would be indexed to wage

growth. Highly compensated employees may not have employer-paid benefits excluded from income that are more than 133 percent of the smallest employer-paid premium made available to 90 percent of the non-highly compensated employees.

One of the largest problems with each of these bills is their requirement that employers offer core health insurance to 90 percent of their employees. It is a fact that, generally, medical insurers require health histories of employees of small businesses. The employees in these small businesses must be individually underwritten; in other words, they cannot obtain group rates. Large employers receive flat, less expensive group premiums for all of their employees; those employers with fewer employees pay on a highly individualized basis. They pay according to age, sex, and medical history. Hence, there are occasions when employees are uninsurable or can only be insured at astronomical cost to the employer.

In the case of employees who may have a pre-existing medical condition (e.g., cancer, even pregnancy), insurers will either refuse to insure those employees or will only agree to insure them for a premium the employer cannot afford. It is not always up to employers who they insure; it is very often a decision of the insurance companies. Employers who cannot offer insurance to 90 percent of their employees should not be forced to suffer; the offer of insurance to 90 percent of insurable employees (as determined by insurance companies)—at reasonable rates—should be sufficient.

Another problem is raised by the 90 percent requirement. If a small business has eight employees, the bill states that it must offer core insurance benefits to 7.2 of them. It is our contention that employers should always be able to round to the next number. Otherwise employers with fewer than 10 employees will always be forced to offer health insurance to 100 percent of their employees.

The caps on employee contributions of $6.70 for individual insurance and $13.40 per week ($10 and $25 in H.R. 1864) for family coverage are designed, understandably, to assure that employers do not simply place employee contributions so high that lower-paid employees are priced out of the health market. However, there are serious problems with the way this principle is implemented. First, both insurance costs and wages are highly responsive to geographics. These absolute figures may be entirely reasonable in one region of the country and totally unreasonable in another. A worker where wages tend to be lower may not be able to afford more than 10 dollars per week for insurance; a worker doing the same job in a more affluent area may have no problem affording a much higher contribution.

Worse, though, than the fixed and inflexible caps set on employee contributions is the manner in which those caps will be indexed, inducing employers to drop their plans. In recent years, health care cost inflation has far outstripped wage inflation. The proposal in HR. 1864 is to index the caps to wage inflation when the cost of health insurance has nothing to do with wages. S. 654 actually indexes increases to increases in the minimum wage. These sorts of indexation may keep employee contributions to a minimum, but they will also have the effect of reducing overall access to health care. Even if the employee contributions were reasonable in the beginning, health care inflation would insure that employers would bear an ever-increasing share of the health care burden.

NSBU would like to take the opportunity to suggest solutions to these problems. NSBU recommends that employee contribution caps for individual and family coverage would be more appropriate at 10 dollars and 25 dollars or 5 percent and 12 percent of income, respectively—whichever is greater. This would allow individuals who make up to $10,400 per year to pay no more than $10 per week for insurance. At the same time, those who could afford to pay a greater share of their health insurance would be able to do so. In order to keep this equitable distribution in place, we recommend that the employee contribution cap be indexed to increases in health care costs. This sort of indexation would allow employers to continue a quality health care plan.

Mr. Chairman, it must be understood that small businesses purchase health care insurance on an individual basis. They often pay vastly different premiums on different employees—based upon age, sex, and past medical history—for exactly the same coverage. The difference in these premiums can often be 200 percent or more. Yet, H.R. 1864 prevents premiums worth more than 133 percent of the value of the smallest employer-paid premium from being excluded from the taxable income of highly compensated employees. It should be realized that highly compensated employees tend to be older employees, and older employees also tend to have more extensive medical records. It will be the case that many of these employees will be paying taxes on the high cost of their insurance even when their coverage is no greater than other employees'—simply because they are older or have greater medical difficulties. We suggest a system whereby the non-excludable portion of employ-

er-paid premium for highly compensated employees would be that which exceeds 133 percent of the average employer-paid contribution. Further, at no time should benefits that are the same as those received by others be taxed simply because of higher premiums. This change would help ameliorate many of the concerns of small business and prohibit what would essentially amount to age discrimination.

We propose the penalties section be delayed for one year; in the interim, employers should be properly notified of their obligations under these regulations (as with the mass-mailing of I-9 forms concerning employers' responsibilities under the new immigration laws). It is reasonable to believe that many small employers may not have a thorough understanding of their requirements otherwise.

Both S. 654 and H.R. 1864 have many benefits over current law—most of which stem from their design-based approach. They tend to be very simple and understandable, eliminating most of the administrative costs and hurdles standing in the way of Section 89 implementation.

We would also like to take this opportunity to call attention to S. 595, a very progressive reform recently introduced by Senator Domenici. S. 595 takes a very different approach from the other reform measures. Among its most helpful changes is an exemption from Section 89 requirements for our smallest businesses. As I have tried to make clear, many of the unique small business problems with Section 89 stem from the fact the small business employees are often individually underwritten. The problems—as outlined previously—arise if the workforce is comprised of employees of different ages or of those with health problems. While the further changes I have outlined would help small businesses to manage their unique problems, these problems would be more easily solved simply by exempting those employers who cannot obtain group insurance and rates from Section 89 rules.

The device for determining which businesses would be exempt is difficult to suggest in that the cut-off point for group underwriting varies from state-to-state, from business-to-business, and from insurer-to-insurer. Language should be written, however, in order to insure that any small business who cannot obtain a group plan would be exempt from Section 89.

Without group underwriting, individual rates may fluctuate greatly. It will, thereby, be very difficult for those businesses—who can afford these plans least—to guarantee affordable health plans to 90 percent of their employees. A large share of the working uninsured are employed by this group of employers. Imposing compliance with Section 89 upon them, given their unique circumstances, gives no incentive for them to expand or initiate employee health benefits. Senator Domenici has provided leadership in order to insure that this contraction of benefits does not occur. His exemption proposal, which has received positive remarks from the Treasury Department—or a similar plan—should be given every consideration.

Mr. Chairman, the dilemma we face is that we must devise a system which allows tax-deductible health insurance to be distributed on an equitable basis, while still allowing employers the necessary incentives to continue to broaden their coverage. It is simply not sensible to attempt to make health insurance distribution more equitable by forcing small businesses to drop their health plans. We must provide them with incentives to provide care more equitably, not disincentives to provide care at all. I hope that our suggestions have been helpful to that end.

I thank the members of the committee for holding these hearings. You have provided a vital service to the small business community. I encourage you to work as hard as possible for the effective reform of Section 89 of the Internal Revenue Code. I pledge to you that we, the members of National Small Business United, will be fighting side by side with you in this important battle. Thank you all very much.

PREPARED STATEMENT OF CARL LEVIN

I would like to thank the Committee for offering me this opportunity to submit testimony with respect to Section 89.

The mail that I have received from Michigan, my recent travels throughout Michigan, the recent testimony of the Treasury Department to the Small Business Committee, and just plain common sense have all convinced me that Section 89 in its current form is a disaster. I have heard horror story after horror story from employers. The only possible conclusion is that Section 89 must be substantially simplified and substantially reformed or it must be outright repealed. The current state of the law is intolerable.

I can understand that Section 89 was drafted with the best of intentions, but the practical result may be in far too many cases the exact opposite of what those who wrote it had in mind. The goal was the equitable distribution of employer provided

health care coverage. The actual effect may be the termination of health care coverage for some employees because employers may find it too costly and administratively difficult to develop a plan which meets the current section 89 requirements. At a time when people are concerned about the rising cost of health care and how they will pay for it, a tax code provision which actually often leads to the cut off of employer provided health care coverage is particularly damaging and must be changed.

I was pleased that the Treasury announced last week that it would delay the enforcement of Section 89 until October 1. The delay demonstrated that the Administration heard the voice of the public and the voice of the Congress. But that is just a starting point, and now it is in the hands of the Finance Committee and the Ways and Means Committee. I know that this Committee will consider a range of options. I would only ask this of the Committee—in working out some solution to this problem put yourselves in the position of an employer. As you try to draft new requirements ask yourselves, "Can I understand this? How many things won't get done if I spend the time to do this? Will I have to hire someone else to do this for me? Will it be easier or cheaper for me to find a way around this than to comply with this?" If the Committee focuses on these questions, it will find a way out of the Section 89 nightmare that will be to the benefit of both employers and employees.

Prepared Statement of Joseph K. Peery

QUANEX CORPORATION

Quanex corporation, headquartered in Houston, Texas, is a steel company manufacturing steel bars and tubes in 9 plants located in Texas, Indiana, Arkansas, Michigan, and Nevada. The company employs approximately 2,000 employees, 97% of whom are full-time workers. These employees are approximately 50% union and 50% non-union. The company's sales in 1988 totalled $462.9 million, mostly to the transportation, machinery and capital equipment and energy processing markets.

QUANEX PROBLEMS WITH CURRENT LAW

Currently, Section 89 provides a set of qualification and nondiscrimination requirements with respect to tax favored employer-provided benefits, primarily, (1) health and accident plans, and (2) group-term insurance plans. If any such plan fails to satisfy the qualification requirements, or discriminates in favor of highly compensated employees, sanctions may be imposed on certain employees, the employer sponsoring the plans, or both.

We as a company agree that the stated purpose of Section 89, fulfilling important social policy objectives such as increasing health insurance coverage for any taxpayers who are not highly compensated, and who otherwise would not purchase or could not afford such coverage, is laudable. But we believe a more simplified approach would be more efficient for achieving that result. Unfortunately, due to the complexity of Section 89, combined with the overly burdensome recordkeeping requirements inherent in the statute's nondiscrimination tests, most companies in corporate America—both large and small—are expending considerable consulting and administrative costs, as well as an inordinate amount of company manpower time, to ascertain whether benefits plans "pass" the tests. Even worse, some employers have contemplated eliminating their plans entirely because they are frustrated with government intervention, specifically Section 89.

As a manufacturing company with 12 locations, Quanex has different, unrelated payroll systems and a multitude of benefit plans, several of which are subject to collective bargaining. currently, complying with the present Section 89 law is a real burden. Quanex offer employees a choice of indemnity-type health plan or HMOs. If an employee chooses one of the available HMOs, he may be required to contribute a small percentage of the monthly HMO premium cost. With respect to the indemnity-type health and accident plans, the company pays the entire cost for both employees *and* their dependent coverage.

Furthermore, for medical costs, the maximum annual out-of-pocket expenditure per employee, due to deductibles and co-pays, is based on a sliding salary scale so that non-highly compensated employees are favored. Under such circumstances, logic dictates that Quanex clearly satisfies the intent and spirit of Section 89.

To perform the nondiscrimination tests required, Quanex would be compelled to restructure its decentralized payroll systems to capture all compensation, benefits, and other human resources information into a single data base. presently, although Quanex offers a variety of fully comprehensive health care plans (i.e. core health,

dental, vision, etc.) at great expense to the company, we additionally must now pay consultants to advise whether our plans pass nondiscrimination requirements. In spite of the best intentions, if the company should inexplicably fail one of the tests, it would be subject to sanctions.

We believe that it might be enlightening to the committee if we describe how some of the provisions of Section 89 impact Quanex.

A. *Testing of Separate Benefit options.* Under present law, different entitlements, coverage options, and employees cost create separate plans for testing. In the case of Quanex, which sponsors an indemnity plan with a multi-tier rate structure, 12 HMOs, each with a multi-tier rate structure, vision care, prescription card, and dental care plans, the number of separate health clans subject to nondiscrimination testing exceeds 100!

Collection and compilation of data from each location into one format for testing purposes will require a significant company expenditure in both manpower and outside consulting costs. Manpower is an important consideration since, during recent difficult years for the steel industry, Quanex, like many companies, reduced its corporate staff by 25% in order to meet competitive pressures. Although the company employs approximately 2,000 workers, the corporate compensation and benefits staff consists of one professional manager and two clerical employees. Plant productivity requires that we concentrate our manpower priorities on manufacturing personnel. consequently, the burdens of data collection for Section 89 testing will place further demands on a corporate staff that is already functioning at full capacity. Given these facts, it is ironic that a company could be penalized for providing comprehensive benefits coverage to its employees.

B. *Part-Time Employees.* Under present law, employees who normally work 17½ hours or more per week must be considered by an employer for testing purposes. Although they amount to less than 3% of the workforce, Quanex does hire part-time employees, many of whom are students and work more than 17½ hours a week. Because compensation and benefit dollars are limited, Quanex prefers to limit benefits coverage to its full-time employees, whose year-round efforts more directly impact the company's financial performance. If part-time workers must be included, the total benefits dollars which are available will necessarily provide less coverage for all employees; further, part-timers' benefits would proportionally represent a much higher percentage of their wages than would full-time employees' benefits.

C. *Union Employees.* In the case of Quanex, all plans covering our unionized employees are employer-provided plans; therefore, under present law Quanex must test these plans. Because these benefits have been bargained for by union representatives, it seems unfair and unreasonable to burden Quanex, as well as other similar employers, by requiring that these plans be tested.

D. *Family coverage.* Under Section 89 an employer may elect to test family coverage and employee-only coverage separately, and to exclude employees from the testing if they have core coverage with another employer. However, the statute presumes that a non-highly compensated employee is not covered by another employer's plan for core benefits, *and* presumes further that a non-highly compensated employee has dependents that are not covered by any other employer's plan. The employer can rebut the presumption of "no other core coverage" by obtaining sworn statements from the employee concerning family status and/or coverage with another employer. of course, collecting and constantly maintaining these sworn statements only adds to a company's recordkeeping burden.

E. *Comparability.* Under current law, as an alternative to the 50% and 90%/50% eligibility tests and the 75% benefits test (ala of which must be passed), plans are nondiscriminatory under an alternative 80% coverage test. To pass the 80% test, 80% of she employer's eligible non-highly compensated employees must be covered by an employer's plan. Any company offering more than one health plan is generally precluded from electing this alternative, unless the plans can be aggregated in order to consider the total number of non-highly compensated employees covered under all of the employer's plans. Section 89, though, permits plans to be aggregated only if they are deemed to be "comparable."

Consistent with its complex nature, Section 89 (and the recently issued proposed regulations thereunder) has established an intricate set of rules and several alternatives to determine whether plans are comparable. Simply stated, "comparability" is determined by comparing the values of the employer-provided benefits under the plans being aggregated. If the values of the employer-provided benefits under the respective plans are within statutorily permissible limits, the plans are deemed comparable. One comparability standard permits an employer to aggregate plans if the difference in *annual* cost to employees between the plans with the highest and lowest cost is $100 or less.

Thus, without fully addressing the issue of benefit "valuation" (a key element of Section 89 testing for which no definitive guidance has been provided, except for transition rules allowing employers to use "any reasonable valuation method"), an employer attempting to pass the 80% test must value its plans being aggregated. This, of course, gives rise to additional consulting costs and recordkeeping burdens.

As stated earlier, Quanex sponsors over 100 group health plans subject to testing. Included in these are fully-insured, self- insured, union-negotiated, and HMO plans. The diversity of these plans makes it difficult to place a realistic comparable "value" on each one, in order to use the 80% test. With over 80% of the non-highly compensated employee group actually covered under its plans, Quanex believes that compliance with Section 89 should be a given. However, compliance is now dependent upon being able to aggregate "comparable" plans which cover a sufficient number of employees.

When employees are given a choice of health care plans, the imposition of complicated comparability rules to determine whether plans can be aggregated means setting an arbitrary standard of value that is subjective, and at best, difficult to determine. Determining the "value" of various plans in order to be able to compare them fairly adds another layer of frustration to the human resources work environment.

We believe the foregoing facts present the committee with a sampling of the multitude of problems that Section 89 is creating for companies like Quanex.

HOW S. 654 HELPS QUANEX

With respect to Senator Pryor's "Section 89 Simplification Act," this is a major first step in potentially eliminating the numerous data collection and recordkeeping requirements currently imposed under Section 89.

Three (3) provisions of Senator Pryor's bill afford Quanex an opportunity to comply with Section 89 (or possibly the new Section 90), or at least to determine compliance thereunder in a more simplified manner.

A. *Simplified Health Arrangements.* By creating a "safe harbor" from Section 89, the "simplified health arrangement" ("SHA") concept represents a sensible, design-oriented approach for determining whether employers maintain nondiscriminatory health care plans.

By combining company-wide eligibility (90% of all employees) with a maximum weekly employee out-of-pocket cost, the design concept offers clear-cut relief from the data collection and testing burdens of Section 89. However, the increasing popularity of HMOs among employees makes meeting set dollar limits for safe harbor difficult. HMO rates are set annually by the Health Maintenance organizations and are dependent upon an HMO's benefit levels, utilization costs, and profitability. These rates tend to vary among HMOs and can fluctuate widely from year to year. For group indemnity plans, however, rates are influenced by whether a company is self-insured, fully or partially insured, and by what types of cost-containment measures have been implemented, etc. A company can exhibit a certain amount of influence over indemnity plan rates, but other than not making HMOs available, companies have little influence on rates HMOs charge. In the case of Quanex, dollar limits under the Pryor bill may be lower than the actual weekly cost to those Quanex employees who choose to be covered under an HMO. To serve the same purpose, perhaps a set dollar amount could be replaced by a maximum percentage that is paid by the employee toward the total premium cost. This flexibility would allow many more companies to qualify for the "safe harbor." The conceptual approach, however, can give employers like Quanex relief from the worst aspects of Section 89.

B. *Part-Time Employees.* We believe that raising the limit on the hours worked per week for part-time employees' exclusion from testing is an improvement. This change will modify the testing of the part-time employee group in a way that more accurately reflects the group's overall contribution to a typical company's productivity and economic well-being.

C. *Aggregation Rule.* As discussed above, for purposes of complying with the alternative 80% coverage test, two (2) or more plans can be aggregated if the difference between the plans with the largest and smallest annual employee cost is no more than $100. Senator Pryor's bill would increase the cost differential to $365. Of course, use of this alternative means that the employer is unable to qualify its health plan(s) as SHA(s), and thus, is subject to the Section 89 requirements. However, any ameliorative changes to the comparability standards permitting compliance under the 80% coverage test are most welcome.

Quanex believes that, if required to comply under Section 89 (rather than the new Section 90), the increase in permissible premium cost differential for aggregation purposes will provide the company with a greater likelihood of "passing" the test.

Although the remaining provisions of Senator Pryor's bill offer relief from some of the burdens of Section 89, the three (3) provisions discussed above give employers like Quanex a reasonable opportunity to simplify the process of determining whether the medical plans maintained are statutorily nondiscriminatory.

SUGGESTIONS FOR MODIFICATIONS TO SECTION 89 THAT WILL HELP EVEN MORE

As stated above, Senator Pryor's bill is a positive first step in the direction of accomplishing the stated purpose of Section 89 in a more logical and simplified manner. However, we believe that additional steps can be taken to ensure that a fair method exists to determine whether health care benefits are being offered on a nondiscriminatory basis, without saddling employers with the complicated and burdensome requirements that currently exist.

Generally, Quanex believes that Section 89 should be completely revamped so that, conceptually, nondiscrimination is determined on the basis of plan design and availability.

In that regard, Quanex would suggest that the simplified health arrangement (SHA) safe harbor of Senator Pryor's bill be expanded to be the sole basis for nondiscrimination determination. That is, the current Section 89 testing requirements would be replaced by the SHA concept similar to recently introduced HR 1864.

Quanex would propose incorporating the following modifications into a revised Section 89.

A. *Availability Test.* An employer's plans would satisfy nondiscrimination requirements if affordable health care benefits are available to at least 90% of the employer's non-highly compensated employees.

The plan would be considered affordable if an employee is required to pay not more than a certain amount for coverage; for example, $45 per month for employee-only coverage or $110 per month for employee with dependent coverage. Alternatively, the limit may be based on an amount tied to a maximum percentage of an employee's compensation, e.g. 4%–5%.

If the employer offers a no cost comprehensive health care option to all of its eligible non-highly compensated employees, then, even if other plans with enhanced benefits (e.g., first dollar coverage HMOs) are offered to the same employees with an out-of- pocket cost, the employer's plans will be considered nondiscriminatory. Further, if the employer offers the same choice of plans to highly compensated employees and non-highly compensated employees, with either no employee out-of-pocket cost or out-of-pocket costs that are proportionately higher for highly compensated employees than non-highly compensated employees, all such plans will be deemed to be nondiscriminatory.

B. *Part-Time Employees.* We believe that with respect to medical benefits, part-time employees should not be given parity with a company's full-time employees. For purposes of this determination, part-time employees would be defined as employees who regularly work fewer than 30 hours per week.

C. *Employees Covered By Collective Bargaining Agreements.* We believe that employers should not be required to test employees covered by collective bargaining. The very nature of collective bargaining gives employees covered thereunder an "arm's length" opportunity to negotiate their own health care packages. It seems inequitable to us after negotiating the collective bargaining agreements, we are required to then determine whether the benefits are nondiscriminatory. The ultimate test of whether benefits are nondiscriminatory in this case should come from the union membership.

D. *Group Term Life.* We believe that the current nondiscrimination rules with respect to group-term life insurance provide a fair and adequate mechanism. Accordingly, we propose that the nondiscrimination aspects of Section 89 be focused solely on medical benefits.

Conclusion. Quanex Corporation appreciates the opportunity it has been given to express its views on Section 89 to the members of the Senate Finance committee and its staff. In conclusion, we would like to say that government efforts to achieve social policy objectives in matters like increasing availability of health insurance indicates a sense of conscience appreciated by taxpayers. However, please understand that a very high percentage of employers throughout this country also have a social conscience, as well as a sense of responsibility to their employees. otherwise, health care plans in the market would not exist, nor would there have been the expansion of health care plans into nontraditional coverage, such as vision plans, dental plans, prescription card services, etc. In that regard, we feel it important that congress fix the problems with Section 89 as expeditiously as possible. A workable, easily admin-

istered Section 89 will, we believe, assure that employees are offered adequate coverage without any need to resort to Mandated Benefits.

PREPARED STATEMENT OF WILLIAM W. RICHARDSON

My name is William W. Richardson and I am Employee Benefits Manager for the Valero Energy Corporation in San Antonio, Texas. I am appearing on behalf of the Employers Council on Flexible Compensation and the Cafeteria Plan Coalition.

ECFC is a non-profit group of over 350 member organizations representing over 10 million American workers. ECFC's members include business corporations, hospitals and clinics, universities, and state and local governments. Council members offer flexible benefits—or cafeteria plans—to their employees. The Cafeteria Plan Coalition is an ad hoc group of over 100 members representing a broad spectrum of the workforce, ranging from city governments to universities to small and large employers to cafeteria plan designers.

I am responsible for plan design and compliance. Valero employs 2000 in four major locations in the state of Texas along with smaller operations both in Texas and in Oklahoma. Our flexible benefits plan includes options in health care, a dental plan, reimbursement accounts for dependent and health care; life insurance, Accidental Death and Dismemberment, a Survivor Income benefit, Dependent Life, Vacation Buy and Sell; and a Long Term Disability program.

As a sponsor of a cafeteria plan, I speak on behalf of thousands of employers who provide their employees with the most innovative and flexible employee benefit arrangements. Cafeteria plans offer employees a choice in the design of their benefit program. Employees are not bound by decisions made by management. Instead, each individual may tailor his or her benefits to his or her specific needs. And as those needs change in subsequent years, the employee may change the benefit program to match his or her new circumstances.

Cafeteria plans offer the following advantages for employees and employers:

First, as I have indicated, cafeteria plans allow employees to choose what is best for them rather than having benefits imposed upon them. According to a 1987 ECFC survey, 97% of women and 64% of men participating in a flexible benefits arrangement expressed reluctance to return to their previous system of imposed benefits. Nine out of 10 women and eight out of 10 men preferred their flexible benefits arrangement to their former benefits programs. Those people realize that today's most needed benefits can best be delivered through cafeteria plans. And cafeteria plans allow two-wage families to avoid the redundant costs of two medical plans. That in itself is a major factor in the appeal of cafeteria plans. Dollars that would be wasted on duplicate coverage can be channeled toward other, needed benefits. These benefits, in a majority of companies, include child care.

Second, employers can introduce a degree of health care cost containment through flexible benefits. Typically, the employer allocates to each employee an amount comparable to the employer's cost for providing benefits under the former, imposed structure. The employee gets to choose where to spend that money—which benefits to take. Employees who take more expensive medical coverage, for example, may not have as many dollars left over to purchase optional coverage such as vision care or dental insurance. Some employees choose less expensive coverage and take the renaming amount in cash in their paychecks, paving taxes as they do on any salary or wages.

Third, employers are being asked by Congress, the Administration and public policy planners to shoulder a larger load in delivering new and innovative benefits. These would include proposals before this Congress to make the offering of child care and other dependent care available in every cafeteria plan. Elder care, funding for post-retirement medical costs, and funding for housing—*all of these* are areas for which public policy planners and legislators see cafeteria plans as the logical answer.

Two facts are important. First, cafeteria plans are not a separate benefit plan in the conventional sense. Cafeteria plans are merely delivery systems for benefits. A multitude of benefits are delivered to employees through the conduct of the cafeteria plan. The tax status of any benefit delivered through a cafeteria plan is not changed simply because it is delivered through a flexible benefits plan and not under a conventional benefit system.

Second, employers who sponsor cafeteria plans have become accustomed to more sophisticated data collection and records-keeping because such records are required to implement the choices made by various employees. Therefore, cafeteria plan sponsors did not have as much difficulty as some other employers in gathering data

and conducting tests under the current Section 89. Section 125, the part of the tax code creating cafeteria plans, has for years imposed discrimination tests upon cafeteria plans. Therefore, most cafeteria plans of which ECFC is aware passed the majority of the current Section 89 rules. Others would pass with relatively minor adjustments. But just the reverse is true under the proposal now under consideration in the House Ways and Means Committee, H.R. 1864. Most cafeteria plans would fall the tests in that bill. Our recommendations regarding that legislation were presented during testimony before the Ways and Means Committee last week and we would be pleased to provide copies or other information if this Committee desires. An important consideration is the tax status of benefits under H.R. 1864.

That legislation would impose a tax on benefits delivered through a cafeteria plan, but not impose a tax on those same benefits when provided outside a cafeteria plan. If Congress believes that revenue must be raised through the taxation of employee benefits, would it not be better to confront that issue head-on? Shouldn't we consider that the socially desirable and utilitarian value of cafeteria plans, as well as the broad acceptance by participants and employers, could be negated? This would mean that current revenue needs could cripple our future ability to provide innovative benefit and compensation programs for American workers.

Some have suggested that employee benefits represent too large a revenue figure to go untaxed. But benefits have been taxed and taxed again in the past few years.

LEGISLATION AFFECTING EMPLOYEE BENEFITS

1. Section 401(k) deferrals were cut from $25,000 to $7,000.
2. The section 401(k) nondiscrimination tests were tightened in 1984 and in 1986.
3. Section 401(k) deferrals were made subject to FICA taxes in 1983.
4. Section 403(b) annuity contributions were cut back to $9,500 in 1986.
5. IRA deductions were restricted for taxpayers who are covered by qualified plans.
6. The maximum annual pension from a qualified defined benefit plan was cut back in 1982 from $136,425 TO $90,000.
7. The maximum contribution limit for defined contribution plans was cut back in 1982 from $45,475 to $30,000.
8. Tax credit ESOPs were eliminated in 1986.
9. A $5,000 limit was imposed on dependent care assistance benefits in 1986.
10. A $5,250 limit was imposed on employee educational assistance benefits under section 127 in 1984 and graduate degree expenses eliminated as a tax-free benefit in 1988. Section 127 expired at the end of 1988.
11. Group term life insurance above $50,000 subjected to FICA tax in 1987.
12. The favorable tax treatment on lump sum distributions from qualified plans was cut back in 1986.
13. A $50,000 limit was proposed on nontaxable loans from qualified plans in 1982.
14. Penalty taxes were imposed in 1986 on qualified plan distributions before a participant attains age 50-and-a-half.
15. Penalty taxes were added for pension plan reversions in 1986.
16. Penalty tax added for reversion from 501(c)(9) trusts (VEBAs) in 1984.
17. Strict deduction limits were imposed in 1984 on advance funding for VEBA benefits.
18. Press limitations were added in 1984 on the types of nontaxable fringe benefits that may be provided to employees.
19. Minimum distribution rules were added to in 1984 for qualified plans to prevent extended deferrals of pension benefits.
20. The $50,000 limit on tax-free employer-provided group term life insurance was extended to group life coverage for retirees in 1984.
21. Group legal service benefits expires as a tax-free benefit in 1988; these benefits were extended in 1988 on a much reduced basis in TAMRA
22. Employer provided van pooling benefits under sec. 124 expired in 1988.
23. The maximum contribution limit for defined contribution plans was cut back in 1982 from $45,475 to $30,000.

Nondiscrimination tests that have a secondary objective—revenue generation—are more difficult to design. We would hope that this Committee would address each separately, if need be, rather than trying to accommodate both in one bill.

We welcome the opportunity to offer our suggestions on designing a system for welfare benefit nondiscrimination testing. We believe that, if tax advantages for welfare benefits are to be conditioned on those benefits satisfying a nondiscrimination test, then the tax advantages of welfare benefits should not be denied simply because employees are given a choice among benefits. We believe that a system for

welfare benefit nondiscrimination testing should be evaluated, in part, based on the effect it has on cafeteria plans. As a matter of horizontal equity, the tax consequences to an employee who receives medical benefits provided unilaterally by his or her employer should not be better (or worse) than the tax consequences to an employee who receives the same medical benefits through a cafeteria plan.

If the tax consequences of providing medical benefits under a cafeteria plan are less desirable than the tax consequences of providing medical benefits unilaterally, employers will be discouraged from offering employees choices among benefits. The policies underlying the enactment of Section 125—a desire to respond to the needs of an increasingly diverse workforce—will be thwarted. While top executives have always had the ability to bargain over their compensation packages, rank-and-file employees generally have had to accept a uniform package of benefits. During the decade since Section 125 was enacted in 1978, employers have found cafeteria plans to be a way to accommodate the diverse needs of their employees.

At the risk of stating the obvious, employees have different needs for benefits at different stages of their lives and with different family responsibilities. An employee with little income beyond his expenses may perceive that he needs a more costly medical plan with lower deductibles and copays than an employee with a high income or substantial financial assets. An employee with a working husband who also has medical insurance may prefer that her employer spend the benefits money not on medical coverage but on dependent care benefits or on a dental plan or on almost anything other than duplicative medical coverage. An older worker may already have medical coverage from other sources and may prefer her current employer to contribute the money which would have been spent on medical coverage for retirement income. The tax system should not discourage employers from providing employees with the benefits they most need or desire.

Recent changes in the laws affecting both welfare plans and pension plans suggest that the advocates of uniformity are prevailing. We believe this trend has negative long-term implications for the financial circumstances of individual employees and for the competitive position of diversified American industries. We encourage you to recognize the advantages of flexible benefits to both employees and employers and to take flexible benefits into account as you work on a nondiscrimination testing system for welfare benefits. We have compiled six suggestions to help you achieve that goal:

1. Discrimination testing should be based on plan design, rather than on actual participation.

Nondiscrimination testing which looks at actual coverage of individual employees increases the burden of testing significantly. To avoid imposing a burden on employers which can yield only marginal benefits, we support the idea of a design-based test. As an employer's plans increase in complexity, the need for a design-based test becomes more acute. For cafeteria plans with numerous elective options available to employees, a test that can be met only by examining actual coverage is a test that creates great uncertainty for both employers and employees.

2. Employer-provided benefit credits should be treated as part of the employer-provided benefit, both for eligibility and for benefits testing.

The dollars used to purchase benefits under a cafeteria plan come from one of two sources—the employer or the employee. When the employer pays for benefits without offering the employees the opportunity to choose something else, the dollars are indisputably employer-provided.

If the employer permits employees who do not want the benefits offered to elect to receive cash instead of benefits, any dollars used to buy benefits are still employer dollars. The dollars that employees receive if they opt out of coverage or opt down to a less expensive level of coverage—and receive taxable cash compensation instead of nontaxable benefits—are sometimes called cashable credits. The mere fact that the employer has given the employee a choice as to how those credits will be spent should not change their characterization from employer money to employee money. Employer-provided credits, including cashable credits, should be treated as employer contributions for all aspects of nondiscrimination testing.

3. Salary reduction, by both higher-paid and lower-paid employees, should be taken into account for benefits testing.

The question of whether contributions are employer or employee money also arises with respect to salary reduction contributions. When an employer pays for benefits or designates a pool of dollars or credits to be used for benefits, the benefits are, from a common-sense standpoint, employer-provided. When an employee pur-

chases benefits with dollars he could have used for other purposes—at any time up to the time the dollars went to buy benefits—the dollars are indisputably employee-provided. Between these two extremes are salary reduction contributions.

Before the beginning of a cafeteria plan year, an, employee and the employer agree that the employee will give up dollars he would otherwise have received as cash compensation in the upcoming year, and in exchange, the employer will use those dollars to buy benefits which the employee prefers to cash. The employee's salary reduction agreement is irrevocable, except in certain limited circumstances, and therefore once the agreement has been entered into, the employee no longer has the right to use those dollars for other purposes. For tax purposes, those dollars are viewed as employer-provided dollars. Accordingly, if the dollars are used to purchase medical coverage or dependent care benefits, they are not taxable under Code sections that exclude certain employer-provided benefits from income.

The treatment of salary reduction contributions for purposes of nondiscrimination testing has been an intractable problem for those who have proposed various nondiscrimination testing systems. The appropriate treatment seems to vary with the type of test being applied. In applying an eligibility or availability component of a nondiscrimination test, we agree that it is appropriate to treat salary reduction contributions as employee contributions. Salary reduction contributions would be treated as employee contributions for determining what level of employer-provided benefits are available or for determining whether benefits are affordable.

Because salary reduction contributions are treated the same way as employer contributions for tax purposes, however, we do not believe it is appropriate to treat salary reduction contributions in their entirety as employee contributions for testing benefits. The drafters of various nondiscrimination rules have taken the position that salary reduction contributions should be treated as employer contributions for higher-paid employees; for higher-paid employees, salary reduction is treated as an employer-provided benefit so that it becomes taxable if the plan is discriminatory. Treating salary reduction for nondiscrimination testing as an employee contribution for lower-paid employees and as an employer contribution for higher-paid employees creates anomalous results for plans which are nondiscriminatory on their face and in operation. We believe that salary reduction should be treated, at least in part, as an employer contribution for lower-paid as well as higher-paid employees.

We acknowledge the concern expressed by drafters of various proposals that employers could nullify a benefits test by simply extending to lower-paid employees the opportunity to buy benefits on a salary reduction basis. There are various ways to address this concern, some of them described in the pamphlet prepared by the staff of the Joint Committee on Taxation. We suggest treating a certain "affordable" level of salary reduction as employer-provided for lower-paid employees. This would alleviate fears that employers would inflate the cap on nontaxable benefits for higher-paid employees by extending extravagant and unaffordable salary reduction benefits to the lower-paid. At the same time, treating salary reduction contributions by lower-paid employees as, in part, employer-provided will prevent a finding that widely-available plans with broad participation are discriminatory. Although there are numerous approaches to testing salary reduction, we believe this approach is administrable and strikes a sensible balance between avoiding employer abuses and accommodating plans which deserve the normal tax advantages of employer-provided medical plans.

4. Affordability indices should be based on medical costs and not on wages.

Our experiences with cafeteria plans covering employees in organizations with diverse geographic locations has made us sensitive to the disparity in medical costs. Also, a goal of some employers who adopt a cafeteria plan is to shift from a "defined benefit" to a "defined contribution" promise in their medical plans. As costs increase, the employer and the employees expect those increased costs to be shared by the employer and the employees. A nondiscrimination eligibility or availability test that looks at whether benefits are affordable must define affordable.

One solution would be to define a plan as affordable if the employee share of the cost did not exceed a stated percentage. Such an approach would respond to the volatility of health care costs, because the maximum employee contribution would rise as the employer's health care costs rise. This would result in an affordability limit that would be appropriate for each employer and the various regions in which the employer operated, while eliminating the incentive to reduce the value of the plan to keep employee cost in line with a less responsive index. Alternatively, if dollar limits are considered necessary, they should be indexed to the cost of health care.

5. A nondiscrimination test should avoid cliff effects in testing benefits.

Generally, cliff effects can be avoided by comparing average benefits available to lower-paid employees to higher-paid employees. In the absence of an averaging approach, employers who provided significant benefits to large numbers of lower-paid employees may find the non-taxable benefits of their higher-paid employees are subject to a cap which does not take those benefits into account at all.

6. Dependent care assistance should be included in the simplification process.

Any effort to simplify Section 89 should also include simplification of the companion nondiscrimination rules for dependent care assistance under Section 129. Tax reform imposed Section 89-type rules upon dependent care assistance that look at actual coverage rather than availability and are complex, requiring extensive data collection. It seems anomalous to leave these complex rules in place while simplifying health care testing. One of the major steps forward in H.R. 1864 is the realization that benefits such as group term life insurance are not tested properly under rules designed for health insurance. That is also true for dependent care assistance.

The preceding changes will allow employers to design cafeteria plans that satisfy reasonable availability tests. This is vitally important in order to put cafeteria plans on an equal footing with other plans. However, employers with cafeteria plans that can satisfy tests of actual coverage should not be required to redesign these plans just to match the availability test requirements. In many cases this would serve only to decrease employee choice and flexibility in plans that are models in nondiscrimination. Employers should be given the option to test their health plans under a simplified coverage test. While some may say that this increases the appearance of complexity, it is important to know that it will have no impact on the vast majority of employers—if a workable availability test is enacted. In addition, coverage-based testing could be made significantly simpler.

Mr. Chairman, we at ECFC and the Cafeteria Plan Coalition will work with you and the staff to accomplish the objective: to prevent bias toward the highly-paid in tax-favored employee benefits. Accomplishing that objective should not require that this nation's most innovative benefits-delivery vehicle suffer. We, as employers, as employees, and as a nation need the flexibility and savings that cafeteria plans offer. Thank you for this opportunity to share our concerns.

PREPARED STATEMENT OF DONALD H. SKADDEN AND DEBORAH WALKER

INTRODUCTION

The American Institute of Certified Public Accountants greatly appreciates this opportunity to offer comments and recommendations prepared by our Federal Tax Division on ways to simplify the rules applicable to employee benefit plans under section 89 of the Internal Revenue Code.

The AICPA is the national, professional organization of CPAs with over 280,000 members. Many of our members are tax practitioners who work with millions of American taxpayers, both individuals and businesses. We are deeply concerned with the effect of section 89 upon businesses of all sizes, in all sectors of the economy.

The AICPA applauds the Chairman and the entire committee on undertaking the important task of providing meaningful relief from the myriad of complex rules contained in section 89. We understand your desire to simplify the law while, at the same time, maintain a tax policy that encourages the expansion of health care coverage for all workers and minimizes the tax subsidy for highly compensated employees if benefits are provided on a discriminatory basis. We believe that the new legislation must be understandable by the taxpayer, administrable by the government and not so burdensome or costly as to defeat the very goals it is attempting to accomplish.

The AICPA recommends that new legislation be adopted to replace section 89. The new rules should not be an alternative to, or a safe harbor means of, avoiding the existing rules.

The AICPA strongly recommends that the new legislation adopt a design-based approach, focusing on plan availability rather than plan coverage. We believe that this approach can be both simple and effective. This approach eliminates the need for sworn statements, separate testing of family coverage and, in some situations, valuation of benefits.

In conjunction with the design-based approach, certain taxpayers may be better served with a discrimination test which regulates the tax subsidy for highly compensated employees based on the benefits actually received by nonhighly compensat-

ed employees. These employers should have the opportunity to accumulate data and compute certain tests necessary to determine if benefits are nondiscriminatory. These rules should be simpler than existing rules. However, because actual coverage would be tested, separate testing for family coverage, sworn statements, and valuation of all plans would probably be necessary. Employees who choose to use the more complicated tests should be given the opportunity to do so without penalizing employers who want to avoid them.

THE DESIGN-BASED APPROACH

The AICPA supports a design-based system similar to that included in Chairman Rostenkowski's proposed legislation (H.R. 1864). In his bill, tax-favored benefits are available to highly compensated employees to the extent an affordable health plan is available to 90 percent of all includable employees.

The desire to expand health care coverage and the need for a design-based test dictates that a high percentage of workers be eligible for the plan. The percentage selected for the eligibility test is interrelated with other troublesome issues, such as, the definition of part-time employees, the treatment of leased employees, the adjustment of excludable employees for plan coverage and duplicate coverage by employees.

Part-time employees

We believe that the excludable part-time work force should be those employees working less than 25 hours per week. Employees normally working less than 40 hours per week and 25 hours or more should have the required health coverage proportionally adjusted.

Leased employees

Leased employees should be excluded from the test until the definition of a leased employee becomes more clear. All practitioners are aware that the proposed regulations are both extremely broad and vague. A taxpayer cannot be expected to accurately calculate the number of employees to whom benefits must be available if the size of the entire group is unclear.

Leased employees should only be included if there is sufficient control over the means of accomplishing a specific job. There are many valid business relationships where a specific task or project is contracted that should not be included as employee-employer relationships in testing benefit plans. The inclusion of leased employees in testing significantly complicates the testing process by requiring coordination between lessees and lessors.

Excludable employees

In general, we believe the categories of employees outlined in IRC section 89(h)(1) are correct, but exclusion should not be impaired if the employer allows some of those workers into a health plan. This complicates the testing process and penalizes employers for allowing certain employees to participate. For example, assume an employer offered health benefits to employees working 10 hours or more in prior years. When this employer changed health benefit eligibility to employees working more than 25 hours per week, the continuing employees working less than 25 hours and more than 10 hours were allowed to remain in the plan. These employers would be penalized if they were required, in calculating the 90 percent test, to include in the employee group all employees working more than 10 hours per week.

Another situation with inappropriate results occurs when the employer provides immediate coverage for all employees or for some part-time employees, perhaps because they are classified as permanent rather than temporary. For example, an employer may offer health coverage to all employees at the beginning of employment. The employee is classified as part-time or full-time based on actual hours worked during the first three months of employment. If, after three months an employee is part-time, coverage is eliminated. This employer would be penalized if all employees were included in the employee population. If exclusion for part-time employees is not available because part-time employees are provided benefits for three months, the employer who offers more health benefit coverage than required would be penalized by expansion of the group of employees tested.

While we believe plan coverage should not affect the group of otherwise excludable employees, the harshness of the plan coverage rule is lessened considerably if an employer is allowed to separately test employees receiving benefits who otherwise would be excludable employees. If the excludable employees can be tested separately, the plans would usually be nondiscriminatory. This separate testing rule miti-

gates the harsh effect of requiring such employees to be included in the employee group.

The AICPA opposes any rules which require adjustment of the excludable group based on plan coverage. At a minimum, inclusion of the separate testing rule is needed.

Duplicate coverage

In recent years, it has become much more common for individuals to be eligible for health care coverage from two or more sources. For example, an employee may be eligible for coverage through a spouse's employment. A student or part-time faculty member may be covered by a university plan. A student may be covered by a parent's health policy or a plan available through the parent's employment. While this may require a sworn statement, such individuals should be allowed to decline the employer's coverage and be excluded from the employee group. Employers not using the sworn statement could be required to include these employees.

The threshold percentage

To the extent the employee group is defined to include these groups, we would support a lower threshold percentage. The existing pension rules, which do not delineate as many excludable employees, use a series of coverage tests, the most expansive of which is 70 percent of all nonhighly compensated employees. A lower threshold percentage would eliminate the need to exclude from the group so many individuals.

Whatever threshold is selected, we would urge that some provision be made to alleviate the "cliff" effect. For example, with a 90 percent eligibility requirement, the penalty for failure to satisfy that test should be phased in from no penalty with 90 percent eligibility, to the full penalty at less than 70 percent eligibility. While this would involve additional complexity in the legislation, we believe such complexity may be warranted so that highly compensated employees are not unduly burdened where a plan does not satisfy the 90 percent test by a small margin.

A grace period could be provided for employers who fall below the required 90 percent eligibility standard by a certain margin. It is possible for an employer who has met the 90 percent test in prior years to fall slightly below that level due to such things as mergers or unexpected rapid growth in employment. These employers could avoid all penalties for the first year such eligibility test was not met, giving them time to comply. For 1989, the grace period could apply to all employers.

Affordability test

In a design-based approach, some type of affordability test is necessary in order to prevent employers from making their workers eligible for a plan that the workers cannot afford. Ideally, the affordability test would establish an equitable sharing of health care costs between employees and the employer. In addition, it would motivate the employer to continue and perhaps even to improve health care coverage. It should be a cost so low that the employee is motivated to purchase the health coverage. It is of course very difficult to find this ideal balance and even more difficult to project an ideal balance into a future of uncertain price, wage, and health care costs.

We recommend that the employee's maximum contribution be defined as a fraction of the employer's health care cost with a ceiling of no more than a certain percentage of wages. For example, each employee's maximum contribution might be 40 percent of the employer's health care costs, but not more than 5 percent of the individual's wages. This would allow for a continuing realistic sharing of costs and, at the same time, offer the very low income worker an affordable plan. This also avoids the need to specify an inflation adjustment. The affordable plan that is defined as a percentage of the employer's cost will reflect that employer's cost, the difference in regional health care costs, and the difference in costs for different group sizes.

Definition of highly compensated employee

We believe the definition of the highly compensated employee should be simplified. The definition presently in IRC section 414(q) is more complex and restrictive than necessary. While we understand that one consistent definition of highly compensated employees is useful for many employers with a number of different types of retirement and benefit plans, the small employer with only a health plan to test finds the need to use the IRC section 414(q) rules extremely burdensome.

We believe that highly compensated and nonhighly compensated employees should be defined on the basis of the Form W-2 wages before imputation of income. The highly compensated employees should be those earning more than $50,000, ad-

justed for cost of living increases ($54,580 for 1989). The testing could be done based on the Form W-2 for the tax year that ends with or within the testing year. An election to delay inclusion of the taxable benefit similar to the rules of IRC section 89(a)(2)(b) could also be used.

An optional coverage test

Many employers offer many different health benefit plans for different employee groups and typically maintain detailed records of the coverage provided. These employers should be given the opportunity to test the actual coverage provided, perhaps by comparing the average benefits that nonhighly compensated employees receive to the average benefits that highly compensated employees receive. The modification to the group of excludable employees outlined under the design-based approach should also be included here. Included with this test should be a discriminatory terms test similar to that provided in Chairman Rostenkowski's proposal. This is necessary to eliminate executive only plans.

SEPARATE TESTING OF CERTAIN BENEFITS

We do not believe it is necessarily good tax policy to design one set of qualification and testing rules for all types of plans, employers, and groups of employees. We believe cafeteria plans and group term life insurance plans should be governed by sections 125 and 79 respectively, and not included in the design-based test for health coverage. If more precise antidiscrimination rules are necessary, provisions can be focused specifically on those particular types of plans.

Benefits test for cafeteria plans

Cafeteria plans are different from other employer provided health benefits in that the employer often maintains more records, such as the available benefit credit for each individual and the required salary reduction. With these records often readily available on the payroll system, a benefits test based on the average benefits used by the nonhighly compensated employees is relatively easy. We believe the test should be based on the average benefits with the average benefit for the highly compensated employees that can be tax-favored not exceeding 133 percent of the average benefit of the nonhighly compensated employees. This should also provide that all benefits offered within the plan are tested together so that employees choosing child care, health care or other benefits are considered to be receiving tax-preferred benefits of equal value.

While we understand that one objective test can mask a number of inherent problems such as, testing family coverage separately, disregarding employees with other coverage, and sworn statements, we believe that these complications are not insurmountable in the case of a cafeteria plan where records are readily available and constant monitoring of individual choices takes place.

THE QUALIFICATION RULES

We urge that a de minimis number of individuals with no service nexus with the employer should be allowed to participate in a plan without violating the exclusive benefit rule. A plan should not fail to satisfy the exclusive benefit rule merely because benefits are provided under the plan to non-employees on a basis that is not tax favored. Including such individuals will actually increase health insurance coverage. The only problems caused by including such individuals on an after-tax basis could be with adverse selection against insurance companies. Thus, the ability for an employer to include such individuals should be regulated by the insurance industry and their contracts with an employer, not through the tax law.

Penalty for failure of the qualification rules

The penalty for failing the qualification rules should be borne by the employer, rather than employees, perhaps through an excise tax. This tax should be calculated on the cost of the coverage, rather than amounts paid or incurred.

CONCLUSION

In view of the burdens placed on practitioners and businesses by section 89, legislative relief is needed. The cost of compliance is the AICPA's most significant concern and we believe a discrimination test, which focuses on plan availability, will eliminate these concerns. We understand that there is sentiment in the business community and the tax writing committees to exempt from these rules small businesses, for example, an entity with ten or fewer employees or those with gross receipts of less than $500,000. We believe the provisions we have described will make

the discrimination rules much less burdensome for small businesses. The AICPA is pleased to continue working with the committee to accomplish its objectives.

PREPARED STATEMENT OF SENATOR STEVE SYMMS

Mr. Chairman I am pleased we are holding these hearings today. The vote of 98 to 0 in the Senate on April 12 on my amendment to urge the House of Representatives immediately to send us a bill to repeal or modify substantially Section 89 of the tax code was a great victory for all of us. I think the Senate has spoken so loudly and clearly that we will get action on this problem very shortly.

Having reviewed various material regarding Section 89 and having been part of a growing effort to delay or repeal this administrative nightmare, I am increasingly convinced that Congress stepped off into the deep end of an enormous bureaucratic swamp when it adopted this portion of the 1986 Tax Reform Act.

I am confident the testimony we will hear today will shed some light on the quagmire that exists for small and large businesses, as well as local and State governments and non-profit institutions, attempting to comply with several provisions that affect employee benefits.

Section 89 establishes highly complex, new requirements for the tax exemption of employee benefits, all employee benefits. Under this new provision, employers must now calculate "values" to learn whether their benefits qualify for tax exemption. So encompassing is this new regulation, employee benefits will now have to be painstakingly analyzed to determine if they are divided fairly between highly paid employees and rank-and-file workers. This doesn't even taken into consideration that now part-time employees must be included in calculations to determine whether plans are discriminatory.

This entire testing process is so boggling that many employers are writing and informing me that they plan to drop employee benefit programs outright, due to the unreal complexity and extensive costs associated with this monster. I think Thomas Veal of Touche Ross and Co. best summarized this entire—regulation when he claimed that if King George and Parliament had come up withanything like Section 89, it wouldn't have taken seven years to win the Revolutionary war. Quite frankly, Section 89 nearly approaches the dangerous and certainly anti-free market policy of Federally mandated, employer provided benefits.

To make matters worse, the Federal government expects businesses to navigate through this mine filled sea when its own Internal Revenue Service is still unable to come up with a complete set of guidelines to augment existing law—I believe this is correct even today; perhaps our Treasury Department witness will be able to correct me. To date, the I.R.S. has had over two and a half years since the passage of the 1986 Tax Reform Act. To be certain, I'm beginning to wonder if the I.R.S. will be able to implement operating procedures to an extent that the one year delay I've proposed in my bill, S. 89, will be long enough.

I also wish to point out the costs associated with this section of the tax code. Few argue the fact that compliance with these regulations will cost businesses thousands of dollars. The end result will be that cost- conscious business will take a position of either dropping plans or accepting the penalties associated with non-compliance based strictly on cost.

Nearly all employers attempt to offer some sort of an employee benefit program; it simply is good business to reward employees. It seems incredibly ironic to me that representatives of United States citizens that claim to be fighting for the little guy would back a proposal that virtually strips employee benefits from those most in need of such programs. It's not as though employee benefit programs are elitist in nature. It is estimated that some 132 million people in the United States receive employer-provided benefits either as employees or dependents. This is elitism?

And then of course there are the supporters of Section 89 who claim budget deficit rules preclude a vote on this issue. The Joint Tax Committee has claimed that if employers abandon fringe benefit and pension plans because of Section 89, the added tax revenue to the Treasury will be $300 million in 1989 alone. Thus, if we repeal or delay it for one year, we supposedly have to come up with a "revenue offset" or a spending cut of $300 million under the rules of the Budget Act.

This phony revenue estimate is ludicrous, because the costs of compliance with Section 89—for all employers—will exceed a billion dollars. At a marginal tax rate of 34 percent, that cost of doing business will lose $340 million to the Federal Treasury. I claim that repealing Section 89 really won't cost the Federal Treasury any revenue; it certainly will make American business more productive. I love my CPAs and benefit managers back in Idaho, but I would certainly prefer to let all the

money that is going to have to be paid to test and re-test these benefit plans be applied by businesses in Idaho for some other purpose other than the costs of all that testing.

Mr. Chairman, I continue to hear employers state that they have no problem with the general intent of Section 89; however, Congress clearly created a Lochness monster when it enacted Section 89. The regulations will decrease flexibility, increase administrative costs, and ultimately bring about fewer benefits and fewer businesses offering plans.

I have offered several remedies to Section 89 as it now stands on the books. I introduced legislation that will postpone this ruling for one year, allowing us time to further study and decide of we are on the right track with this legislation. We must postpone it, if for no other reason that to send a message to the business community not to drop their benefit programs and wait until a broader knowledge of the implications of section 89 is understood. On April 12, the Senate overwhelmingly adopted Senate Resolution 92, which many of you co-sponsored with me to urge the House of Representatives to take action regarding this legislative headache.

I know that the House of Representatives may at last now be considering a bill to delay this provision, and to make substantial modifications.

Mr. Chairman, I fear that unless. Congress acts quickly, the nation's businesses will drop employee benefit plans outright. For a government which claims to be responsible to its constituents, clearly, a call to action is beckoning. That Congress has insisted on turning the tax code into social legislation is beyond me. The way the Constitution is being interpreted these days, perhaps Congress will next institute central planning or five year plans to deal with perceived inequities in what is supposed to be a capitalist, market based society.

Statement of Blake Hall, Idaho Association of Counties

THE IMPACT OF SECTION 89 ON COUNTY AND MUNICIPAL GOVERNMENTS

Mr. Chairman, one of the issues of greatest concern to the local governments of this country today is Section 89—the provision of the Tax Reform Act of 1986 in which Congress mandated a system of testing employer fringe benefit plans to assure no discrimination against low-paid employees.

Mr. Chairman, I am pleased to be able to testify today before the Senate Committee on Finance because I believe you will soon be introducing legislation to modify substantially the regulatory burdens of this provision in the 1986 Tax Reform Act. The overwhelming vote in the Senate last month on the amendment by Senator Symms, in which the Senate by a vote of 98 to 0 adopted an amendment to urge the House of Representatives immediately to enact a bill to repeal or modify substantially Section 89 of the tax code, was a great victory for all of us. I think the Senate has spoken so loudly and clearly that we will get action on this problem very shortly.

Representing the state and local governments of my State, I want to assure you first that none of our governments discriminate against lower paid employees. Our position representing all the citizens in our communities virtually assures in advance that more highly compensated employees will not receive undue benefits out of proportion to those given to lower paid employees. That, however, does not exempt us from the very burdensome testing requirements.

Having reviewed various material regarding Section 89, I am increasingly convinced that Congress had no idea of what it was enacting when it adopted this portion of the 1986 Tax Reform Act.

So encompassing are these new regulations, employee benefits will now have to be painstakingly analyzed to determine if they are divided fairly between highly paid employees and rank-and-file workers. This doesn't even taken into consideration that now part-time employees must be included in calculations to determine whether plans are discriminatory. Employees who receive more than some average level of health benefits from their employers have to pay income tax on those benefits. The problem, Mr. Chairman, is in trying to determine what is "excessive."

Section 89 of the tax code sets out a complicated series of tests and measurements that employers have to perform to determine if the benefits of their more valuable, more highly compensated employees are "excessive" or not. This has turned into a great big nightmare—a complete mistake on the part of the 99th Congress that must be corrected as quickly as possible, before it is too late.

This entire testing process is so unreal that many employers in Idaho, both in county and municipal governments as well as the business sector are planning to drop employee benefit programs outright, due to the unreal complexity and extensive costs associated with this well-intended legislation. Quite frankly, Section 89

nearly approaches the dangerous and certainly anti-free market policy of Federally mandated, employer-provided benefits.

To make matters worse, the Federal government expects local governments and businesses to comply with this unreal legislation at a time that the Internal Revenue Service is still unable to come up with a complete set of guidelines to augment existing law. To date, the I.R.S. has had over two and a half years since the passage of the 1986 Tax Reform Act.

I also wish to point out the costs associated with this section of the tax code. Few argue the fact that compliance with these regulations will cost local governments and businesses thousands of dollars. The end result will be that cost-conscious government and business will take a position of either dropping plans or accepting the penalties associated with non-compliance based strictly on cost.

Nearly all employers attempt to offer some sort of an employee benefit program; it simply is good business to reward employees. It seems incredibly ironic to me that representatives of United States citizens that claim to be fighting for the little guy would back a proposal that virtually strips employee benefits from those most in need of such programs. It's not as though employee benefit programs are elitist in nature. It is estimated that some 132 million people in the United States receive employer-provided benefits either as employees or dependents. Is this elitism?

Recently there's been a phony revenue amount tossed around the halls of Congress that the Treasury would supposedly loose. The last I heard it was close to 300 million dollars. This estimate is ludicrous, because the costs of compliance with Section 89—for all employers—will exceed a billion dollars. At a marginal tax rate of 34 percent, that cost of doing business will lose $340 million to the Federal Treasury. I claim that repealing Section 89 really won't cost the Federal Treasury any revenue; it certainly will make American government and business more productive.

Mr. Chairman, employers have no problem with the general intent of Section 89; however, Congress simply went too far when it enacted Section 89. The regulations will decrease flexibility, increase administrative costs, and ultimately bring about fewer benefits and fewer employers offering plans.

I believe the best action Congress could take at this time is to delay implementation and send a message to local governments and the business community not to drop their benefit programs. Congress needs broader knowledge of the implications of section 89.

Mr. Chairman, I fear that unless Congress acts quickly, the nation's local governments and businesses will drop employee benefit plans outright. For a government which claims to be responsible to its constituents, clearly, a call to action is beckoning. That Congress has insisted on turning the tax code into social legislation is beyond me. Local Governments and businesses are urgently waiting on Congress to act. I urge you all, as members of the Senate Finance Committee, to move forward quickly with legislation to either modify or repeal this current regulation. As it stands now, America's local government and private sector is at a loss as to what do.

LLOYD BENTSEN,
Chairman, Senate Finance Committee,
U.S. Senate,
Washington, DC.

Dear Mr. Bentsen: As Mayor of the City of Rupert, Idaho, and as an independent newspaper publisher, I urge the Senate Finance Committee to amend or repeal Section 89 of the Internal Revenue Code to eliminate the complex rules and regulations relating to tax treatment of employee benefits.

I support the concept that the government should not subsidize fringe benefit packages which give greater tax free benefits to highly compensated employees and owners than to lower paid workers, but I strongly object to the manner in which Section 89 attempts to implement this policy.

Small businesses and small governmental units cannot afford to spend their limited resources on lawyers and accountants for purposes such as compliance with Section 89 of the Internal Revenue Code. We are lucky if we have enough money to offer limited fringe benefit packages to our employees. Why should we be required to divert our limited resources to tax compliance expenses and possible penalties for non compliance when we desperately need to apply our resources to productive purposes for survival.

A simple, straight-forward solution would be to require that all health related fringe benefit packages of an employer be equal for all employees on a per capita basis after a six month probationary period for new employees and that all pension

and profit sharing plans of an employer be equal for all employees as a percentage of their regular compensation after a six month probationary period. If the plans will not withstand an audit there should be substantial penalties to the employer. This approach will accomplish the purposes of Section 89 and will eliminate an unnecessary burden on employers.

Very truly yours,

W.F. "BILL" WHITTOM, *Mayor.*

PREPARED STATEMENT OF ANTHONY C. WILLIAMS

INTRODUCTION

Mr. Chairman and members of the Committee, my name is Anthony C. Williams. I am the Director of the Retirement, Safety and Insurance Department of the National Rural Electric Cooperative Association (NRECA) and the Administrator of the various welfare and pension programs sponsored by NRECA for its members. NRECA is the national service organization of the approximately 1,000 rural electric service systems operating in 46 states. These systems bring central station electric service to approximately 25 million farm and rural individuals in 2,600 of our nation's 3,100 counties. Our various programs provide pension and welfare benefits to over 125.000 employees and their dependents in those localities.

SECTION 89 AND HEALTH CARE COVERAGE

NRECA has participated actively in the ongoing public policy debate over expanding health care coverage. Two research reports commissioned by us in 1988 provided new information on this issue. The first report examined health care coverage among small rural businesses in rural electric cooperative (REC) service areas. The second report used experience in NRECA's own health insurance plans to evaluate the potential costs of universal health care coverage. Both reports were widely distributed to Congressional and Administration policy makers as well as interested individuals and organizations across the country.

Based on its experience and interest in employer-provided health care plans, NRECA is seriously concerned about the effect of Internal Revenue Code section 89. Section 89 attempts to encourage employers to expand health care coverage among their employees and limit the share of coverage-related tax expenditures accruing to highly compensated employees.

NRECA supports the policy goals of expanding access to health care coverage and ensuring that coverage is nondiscriminatory. We believe that section 89 is an unnecessarily burdensome way to achieve these goals, however.

Even as national health care costs rage out of control, the law increases employers' costs of adopting, maintaining, and improving a health care plan. Our survey of employer-provided health care coverage in smaller firms found that cost is their major barrier to coverage. Since rural areas depend on employment in small firms to a greater degree than urban areas, low coverage in smaller firms particularly affects rural areas.

Public concern is also mounting over inadequate coverage of prenatal care, well-baby care, and various pre-existing conditions in employer plans. Section 89, however, forces employers to spend money on statistical testing rather than on improving benefits.

REFORMING SECTION 89

While NRECA would support the repeal of section 89, we are prepared to offer suggestions for mitigating its burdens while achieving its stated goals. Some of the reform elements discussed below are contained in legislative proposals, including S. 654, introduced by Sen. David Pryor (D-AR), H.R. 1864, introduced by Rep. Dan Rostenkowski (D-IL), and S. 595, introduced by Sen. Pete Domenici (R-NM). Other elements arise from our own evaluation of the problems this law causes.

The Law

For a welfare plan to be nondiscriminatory under section 89, it must meet certain standards both in the choices offered to employees and in the choices the employees make. Plans must meet a three-part eligibility test and a benefits test, or may elect to use an alternative test in lieu of the eligibility and benefits tests. Under the eligibility tests:

• either nonhighly compensated employees must constitute at least 50 percent of eligible employees, or the share of highly compensated employees eligible to participate must be no larger than the share of nonhighly compensated employees eligible;
• at least 90 percent of nonhighly compensated employees must be eligible to participate in a health plan offered by the employer, and if they did participate, would receive a benefit at least 50 percent as valuable as the most valuable benefit available to any highly compensated employee; and
• eligibility provisions may not discriminate in favor of highly compensated employees.

The benefits test provides that nonhighly compensated employees must receive an average benefit equal to at least 75 percent of the average benefit provided to highly compensated employees.

Under an alternative test, a plan that benefits at least 80 percent of nonhighly compensated employees satisfies both the eligibility and benefits tests, provided that employees are not just eligible but actually received coverage.

Section 89 and Smaller Employers

The 80 percent alternative test was intended to be useful to smaller employers. We have found, however, that many employers who do not offer discriminatory benefits will, nevertheless, be unable to use it.

Our survey found that 82 percent of smaller employers with health coverage plans offered a traditional indemnity plan, with most of the remainder offering a managed care arrangement (Figure (1). Of the surveyed firms, 78.3 percent reported participation rates of 75 percent or higher among full-time employees (Figure (2). These firms would probably have met the 80 percent alternative test. The remainder, with an average participation rate of 47 percent, would have had to use the more complex three-part evaluation.

Our preliminary estimates show similar results among RECs, most of which are also small employers. About one-third of the RECs participating in NRECA plans will be unable to use the 80 percent test.

NRECA believes that employers who make health coverage available to all their employees, on a fair basis, should not be penalized for their employees' elections. If plans have low participation rates because coverage is not affordable for employers or employees, the problem should be addressed directly. Available means include improved risk sharing arrangements for smaller firms and tax code changes. Penalizing employers for the high cost of health care does not change it.

Accordingly, NRECA adds its voice to those advocating that nondiscrimination tests be based on eligibility for benefits rather than coverage or benefits received.

Contributions

The Pryor and Rostenkowski bills would reduce testing requirements, but would impose limits on the employee contributions that could be required. The Pryor bill would eliminate the testing requirement for plans meeting certain requirements, including mandatory contributions limited to the lesser of 5 percent of the minimum wage or $6.70 per week for employee coverage and $13.40 for family coverage. The Rostenkowski bill would eliminate testing for all plans but would limit employee contributions to $10.00 per week for employee coverage and $25.00 for family coverage.

Limits on allowable contributions reflect concern over maintaining the affordability of coverage and avoiding discriminatory benefit patterns. We believe, however, that fixed-dollar limits may not assure the affordability of coverage for all employees, while they could discourage employers from adopting plans and from offering dependent coverage.

Contribution limits could impose a disproportionate burden on small employers. Small employers often pay more for the same health care coverage than larger firms. Our survey found that small firms are more likely than larger firms to require employee contributions, and that nearly one in ten of covered employees in small firms pays the entire cost of coverage.

Accordingly, we urge that any contribution limits be set with the needs of small employers in mind. The minimum wage should be just that. If contribution limits are to be imposed, employee contributions should not be allowed to reduce compensation below this level. Past this point, however, employers should have flexibility in setting contribution requirements, so long as differences in contributions among plans reflect plan value. This goal could be accomplished, for example, by limiting the share of premiums employees could be required to pay.

If contribution limits are imposed. they should reflect employer practices in pricing coverage. Many employers who do not require contributions for employee-only

coverage do impose them for family coverage. Where contributions are required for both types of coverage, in turn, the differentials tend to be larger than those in the Pryor or Rostenkowski bills.

To take account of these patterns, we propose that employers be allowed to apply "unused" employee-only contribution limits to required family coverage contributions. For example, under the Pryor approach, an employer who required no contributions for employee-only coverage could be allowed to charge up to $20.10 ($6.70 + $13.40) for family coverage. Alternatively, we suggest that more flexible rules governing the differential between employee-only and family coverage be devised.

We are also concerned that contribution limits could be used to restrict flexible benefit plans. We understand, for example, that the Rostenkowski bill would foreclose the type of health plan under which the employer finances core coverage and the employee adds additional benefits through salary reduction. Such plans have been an important element of employers' efforts to respond to the needs of a diverse workforce as well as contain health care costs. We urge the Congress to take the needs of flexible benefit plans into account in revising section 89.

Part-Time Employees

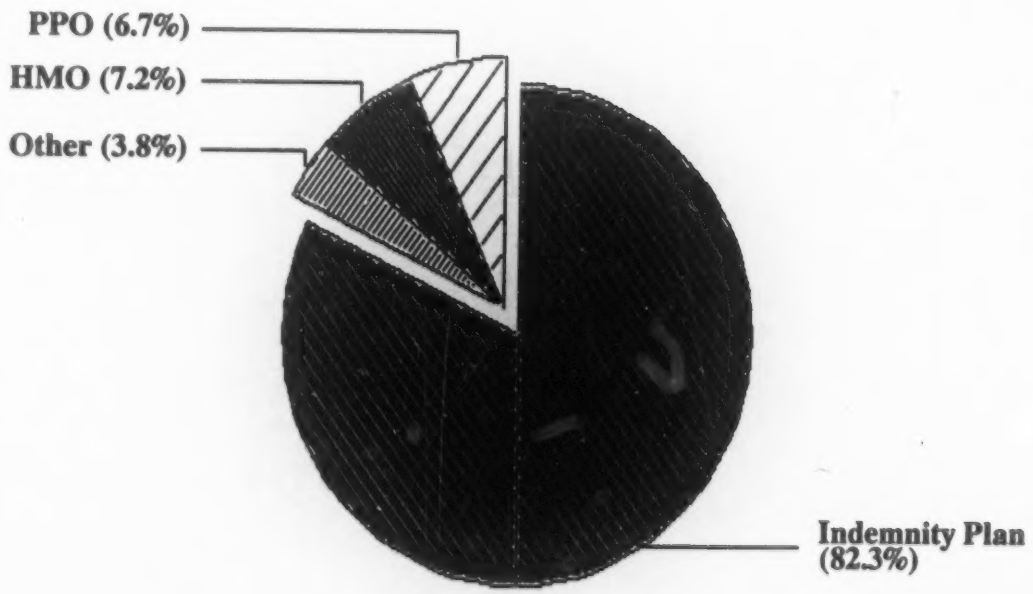
Small firms depend on part-time workers significantly more than do larger employers. Consequently, the part-time exception contained in current law seriously concerns both smaller employers and rural areas. Employer-sponsored health care plans are a very efficient way to deliver coverage to U.S. workers and their dependents. Employer plans, particularly in smaller firms, cannot provide coverage to those without a significant attachment to the labor force, however.

The Pryor, Rostenkowski, and Domenici proposals would raise the threshold at which part-time employees would be counted in the discrimination test. We support such measures. Below this threshold, employees could be made eligible to purchase coverage in the employer's plan at group rates.

EFFECTIVE DATE

NRECA urges that the section 89 effective date be delayed until at least January 1, 1990, or that penalties for noncompliance be waived until that date. The complexity of the rules, the delay in issuing regulations, and the ongoing legislative debate have all contributed to confusion for employers. Employers should not be expected to carry out tests, and perhaps make plan changes. in this environment, and they should not be penalized for waiting. The effective date for compliance by smaller employers should be deferred an additional year to reflect their greater costs of compliance.

Figure I
Health Care Plans
in Smaller Firms

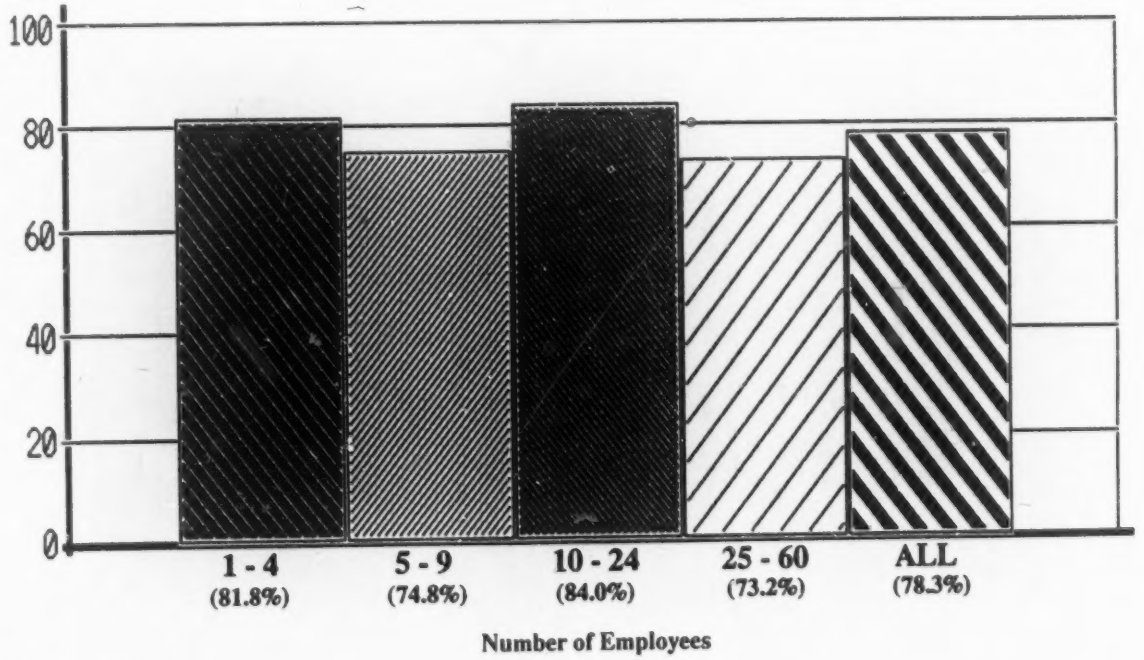


Source: NRECA Survey

FIGURE II

Employers With 75% or More Eligible Employees

Participating in Health Plan



Source: NRECA Survey

PREPARED STATEMENT OF DANA L. TRIER

Mr. Chairman and Members of the Committee: I am pleased to be here today to discuss the Administration's views regarding the nondiscrimination and qualification rules applicable to certain employee benefit plans under section 89 of the Internal Revenue Code. As we have testified before other Congressional committees, the Administration believes that section 89 is overly complex and imposes undue compliance burdens on employers. We are pleased that Congress is promptly addressing these problems, and the Treasury Department looks forward to assisting Congress in developing an adequate legislative solution. To facilitate the legislative process, the Treasury Department and the Internal Revenue Service last week announced additional transitional relief provisions that are designed to provide Congress with sufficient opportunity to develop legislation before employers are required to expend substantial further resources to comply with the statute.

In the first part of my testimony, I will describe briefly the provisions of section 89 and the policy rationale underlying those provisions, the transitional relief treatment under the regulations, and certain proposed legislative replacements of section 89. I will then discuss the core issues the Administration believes must be addressed in fashioning any new legislation. Finally, I will conclude by summarizing the Administration's position on the revision of section 89.

BACKGROUND

A. Statute.

The Internal Revenue Code provides that certain employer-provided benefits are excludable from the gross income of employees. For example, employer-provided health coverage and benefits are excludable under sections 105 and 106, employer-provided group-term life insurance is excludable under section 79 and employer-provided dependent care assistance is excludable under section 129.

Section 89 provides that health coverage and group-term life insurance may be excluded from the income of highly compensated employees only to the extent that the coverage and insurance is provided on a basis that does not discriminate in favor of highly compensated employees within the meaning of certain statutorily imposed nondiscrimination tests. In addition, employers may elect to test their dependent care assistance programs under the nondiscrimination rules of section 89. The rationale for limiting the income exclusions is that the tax expenditures are justified only if nonhighly compensated employees are provided benefits that are comparable to the benefits provided to highly compensated employees. In enacting section 89 and other employee benefit nondiscrimination rules in 1986, Congress was concerned that the prior law nondiscrimination rules did not require sufficient coverage of nonhighly compensated employees as a condition of the exclusions. The President's 1990 budget reports that the revenue loss tax expenditure in 1990 for employer-provided health coverage will be $29.6 billion, for group-term life insurance, $2.2 billion, and for dependent care assistance, $155 million.

Under section 89 an employer may choose to determine whether a plan satisfies the nondiscrimination rules under one of two testing methods. Under the first method, a plan satisfies the rules if it satisfies three eligibility tests and a benefits test. The first eligibility test is that at least 50 percent of the plan participants must be nonhighly compensated. The second eligibility test is that at least 90 percent of the nonhighly compensated employees must be eligible for a benefit at least equal to 50 percent of the greatest benefit available to any highly compensated employee. The third eligibility test is that the plan may not contain any provision relating to eligibility that, by its terms or otherwise, discriminates in favor of highly compensated employees. This test is intended to address those instances of discrimination that are not quantifiable, such as whether benefits are, in fact, available to nonhighly compensated employees and whether more favorable eligibility waiting periods are provided to highly compensated employees. The benefits test is satisfied if the average value of all employer-provided health coverage received by nonhighly compensated employees is at least 75 percent of the average value of employer-provided health benefits received by highly compensated employees.

Under the second testing method, a plan satisfies the nondiscrimination rules if it benefits 80 percent of the employer's nonhighly compensated employees and if it does not contain, by its terms or otherwise, any discriminatory provision.

The definition of highly compensated employees under section 89 is the same as that used for other employee benefits. The Internal Revenue Code generally defines a highly compensated employee as any employee who, during the current year or the prior year, is one of the following: (i) a 5 percent owner; (ii) an officer receiving compensation in excess of $45,000; (iii) an employee receiving compensation in

excess of $75,000; or (iv) an employee receiving compensation in excess of $50,000, who is among those 20 percent of employees receiving the greatest compensation from the employer. The Code provides that the relevant dollar amounts are indexed for inflation.

When testing its plans, an employer generally may exclude those employees who are not yet age 21, those who normally work less than 17½ hours per week, those who normally work not more than six months per year and nonresident aliens receiving no United States source income.

B. Transition Rules Under the Proposed Regulations.

In the proposed regulations promulgated in March of this year, the Treasury Department and the Internal Revenue Service attempted to be very flexible in implementing section 89 so that employers could more easily bring their plans into compliance. The proposed regulations provide several transitional provisions that apply in 1989. First, the regulations provide that employers who reasonably and in good faith comply with section 89 and its legislative history in 1989 will be treated as having satisfied section 89. In addition, the proposed regulations provide that employers who elect not to test whether their plans satisfy the 75 percent benefits test in 1989 may include in the income of certain of their highly compensated employees all of the employer-provided health coverage. This election relieves employers of most of the data collection and testing burdens. The highly compensated employees who must include in income all of the employer-provided health coverage are the 20 percent of such employees who receive the greatest compensation from the employer, but not less than ten employees nor more than 2,000 employees. This transitional provision is extended to 1990, except that the number of highly compensated employees who must include all of the employer-provided health coverage in income is greater. Finally, employers may generally ignore facts in existence prior to July 1, 1989 when testing their plans for compliance in 1989. Employers who chose to take advantage of this relief merely annualize the benefits provided after July 1 to determine whether their plans are discriminatory.

On May 1, 1989, Secretary of the Treasury Nicholas F. Brady announced the July 1, 1989 optional beginning date of the 1989 testing year provided in the proposed regulations would be changed to October 1, 1989. On May 5, 1989, the Internal Revenue Service published Notice 89-65 implementing the October 1 testing period commencement and announcing that the July 1, 1989 deadline for providing eligible employees reasonable notice of benefits available under certain plans is postponed until October 1, 1989.

C. Proposed Legislation.

In response to the perceived problems with section 89, several bills have been introduced in the Senate and House of Representatives. S. 654, introduced by Senator Pryor and others on March 17, 1989, would modify section 89 in several ways. First, it would provide that an employer would not be required to test its health plan under section 89 if the plan qualified as a simplified health arrangement, which generally is a plan in which 90 percent of the employees are eligible to participate and the cost to the employees does not exceed certain defined maximums. In addition, the definition of part-time employee would be changed to an employee generally working 25 hours or less, with a phase-in of 30 hours in 1989 and 27.5 in 1990. The treatment of family coverage, employee cost comparability, valuation of benefits, and testing dates would also be modified. Finally, the sanction for failure to meet the qualification requirements would be modified so that only highly compensated employees would be required to include in income the value of coverage.

S. 595, introduced by Senator Domenici and others on March 15, 1989, would delay the application of section 89 until plan years beginning after December 31, 1990 and make section 89 inapplicable to any employer who employs less than 20 employees. In addition, the definition of part-time employee is changed to an employee normally working less than 25 hours. Finally, the bill creates an eligibility safe harbor that allows an employer to satisfy section 89 if all of its nonhighly compensated employees are eligible to participate in a plan as valuable as the most valuable plan available to any highly compensated employee, and changes the 80 percent alternative coverage test to a 65 percent coverage test.

S. 89, introduced by Senator Symms and others on January 25, 1989, would delay the effective date of section 89 for one year. S. 350 introduced by Senator Lott and others would repeal section 89.

H.R. 1864, introduced by Congressman Rostenkowski and others on April 13, 1989, would make several changes to section 89. First, the various section 89 nondiscrimination tests would be replaced with one simplified test, under which a plan containing no discriminatory provision would qualify if it meets two requirements: (1) it

provides primarily core health coverage to at least 90 percent of the employer's nonhighly compensated employees at a cost of no more than $10 per week for individual coverage and $25 for family coverage; and (2) the maximum amount of employer-provided coverage of any highly compensated employee is not more than 133 percent of the affordable employer-provided coverage made available to 90 percent of the employees. Second, part-time employees normally working less than 25 hours would not be required to be covered. Third, leased employees could generally be disregarded if the employees are covered under a core health plan meeting the nondiscrimination tests. Fourth, employees covered by a collective bargaining agreement are tested separately. Fifth, officers with compensation not in excess of $45,000 will not be considered highly compensated. Sixth, the nondiscrimination rules in effect prior to the Tax Reform Act of 1986 are made applicable to group-term life insurance. Finally, the present law sanction for failure to qualify is changed to an excise tax on the employer equal to 34 percent of the cost of coverage.

ISSUES TO BE RESOLVED IN LEGISLATION

Several aspects of the operation of section 89 have received particular attention in recent weeks, as the process has begun of replacing section 89 with a workable provision. Some of the most important areas of concern are discussed below. Others may arise as the discussion proceeds. Although the issues involved are difficult, we intend to work with Congress to formulate resolutions of all of these issues as soon as practicable. It is imperative that the final statutory solution that is enacted resolve all of the outstanding issues in a satisfactory manner.

A. Nondiscrimination Rules.

The basic objectives of the nondiscrimination tests are the elimination of plans providing tax-favored health benefits only to highly compensated employees and the promotion of coverage of nonhighly compensated employees. These objectives must be achieved by means of workable tests that can be understood by employers and applied without undue expense in a wide variety of circumstances. In this context, employers are confronted with several overriding problems of statutory design, including particularly (i) the problem of valuation of benefits, (ii) the question of which employees may be excluded, (iii) the treatment of salary reduction contributions, and (iv) the special considerations applicable to small businesses.

1. Valuation. The most fundamental problem in determining compliance with section 89 in its current form has been the necessity of reliance upon valuation of benefits. It has become clear that the problems with valuation simply were not understood in 1986 when section 89 was enacted. Valuation has proved to be not only a very complex task, but an expensive one as well. Thus, to be viable, any legislation replacing section 89 must confront the problems posed by reliance upon valuation of benefits.

At a minimum, employers should be assured, under the statute, that an employer's cost may be viewed as the value of the benefit. In addition, the Treasury Department should have the authority to develop other reasonable valuation methods.

More important, it is crucial to replace the current nondiscrimination tests with a test or tests which are to the fullest extent possible "design based," i.e., tests which the employer may be confident it has passed without undertaking a complex valuation of benefits. In this regard, the efforts of Senator Pryor and Congressman Rostenkowski are important first attempts. In the case of both S. 654 and H.R. 1864, the testing for nondiscrimination would, in part, be generally based on the required availability, at affordable costs, of health insurance coverage to 90 percent of the employees.

Three different types of questions are raised with respect to design-based tests of the types included in S. 654 and H.R. 1864. First is the question of the percentage of nonexcludable employees to whom coverage is required to be offered. Both Senator Pryor and Congressman Rostenkowski have required that, generally, 90 percent of nonexcludable employees be offered coverage. Others have suggested that, in the alternative, the nondiscrimination test be based on the relative proportion of highly compensated and nonhighly compensated employees covered. We believe that such an alternative test is worthy of consideration so long as the implementing provision does not sacrifice the underlying policy goal of broadly available affordable health coverage.

The second problem to be considered with a design-based test is the "cliff effect" such a test often has. For example, an employer providing the option of coverage to a group of employees constituting only slightly less than the required percentage, may, in fact, pay a large portion of the cost of providing health coverage to nonhighly compensated employees. It seems inappropriate to impose on such an employer

the full sanction for failure to satisfy the test, when another employer actually providing very little health coverage could very well meet the availability tests.

We believe Congress should consider ways of ameliorating the cliff problem. It is important, however, in addressing this problem not to re-introduce statutory complexity and onerous valuation procedures.

The third question is the extent to which it is necessary that a designed-based test be accompanied by an overriding provision limiting the extent to which the employer-provided benefit of highly compensated employees can exceed that provided to or made available to nonhighly compensated employees. H.R. 1864, for example, limits the employer-provided health benefit available to highly compensated employees to 133 percent of that available as a core health benefit to 90 percent of the employees under the basic plan. Although we recognize that this test would not require full scale valuation because only the employer-provided benefit of highly compensated employees must be valued, we also believe that the administrability and simplicity of the new provision would be improved if valuation requirements could be limited even further.

2. Employees Taken Into Account. If relatively strict, broadly based eligibility tests are included in any new legislation, consideration should be given to expanding the classes of employees who may be excluded from the tests in certain cases. For example, governmental entities and charitable organizations, as well as for-profit entities, sometimes hire handicapped adults for rehabilitation or job-training purposes, for whom insurance companies often will not provide coverage. If these individuals receive health benefits under Medicaid or other governmental programs, perhaps employers should be permitted to consider such individuals as excluded employees.

In addition, we believe it is appropriate to relax the definition of part-time employee. We note that in this regard that several of the bills have adopted a 25-hour standard to replace the 17½ hour standard of current section 89.

3. Salary Reduction Contributions. The Internal Revenue Code generally provides that salary reduction contributions to a health or group-term life insurance plan are employer contributions. For purposes of determining whether at least 90 percent of nonhighly compensated employees have available a benefit at least equal to 50 percent of the benefit available to any highly compensated employee (the 90/50 percent eligibility test), however, an employer may elect to treat salary reduction contributions as employer contributions only if three conditions are satisfied. First, all employees must be eligible to participate in the plan under the same terms and conditions. Second, the percentage of an employer's nonhighly compensated employees eligible to participate cannot exceed the percentage of an employer's highly compensated employees so eligible. Third, no highly compensated employee eligible to make salary reduction contributions may be eligible to participate in any other employer plan of the same type unless the other plan is available on the same terms and conditions to nonhighly compensated employees. If these three conditions are not satisfied, salary reduction contributions are treated as employee contributions for purposes of the 90/50 eligibility test.

The proposed regulations generally provide that, notwithstanding the rules set forth in the previous paragraph, a highly compensated employee's salary reduction contributions used to purchase core health benefits are treated as employer contributions for the purpose of the 90/50 percent eligibility test only to the extent that such contributions exceed other employer contributions made on the employee's behalf for core health coverage. Similarly, core health coverage attributable to a nonhighly compensated employee's salary reduction contributions are treated as employee contributions to the extent that such contributions exceed employer contributions (excluding salary reduction contributions) made on the employee's behalf to provide core health coverage.

The Administration believes that any new legislation should consider the effect of restrictive rules regarding the treatment of salary reduction contributions on the willingness of employers to maintain cafeteria plans. If it is determined that there are certain types of health expenses that should not be reimbursed or otherwise paid under a cafeteria plan or other flexible spending arrangement, this problem should be addressed directly.

4. Small Business Considerations. The special circumstances faced by small businesses should be addressed in any legislation enacted to revise section 89. The situations of small businesses may differ in several respects from those of other businesses to which section 89 is applicable. First, the relative burden of the costs of determining compliance may be significantly higher. Second, because some small businesses have only a few employees, a small change in the number of employees in the workforce may have a disproportionate impact under the various tests. Third,

insurance companies often treat small businesses in ways different than they treat larger employers.

Although we do not support a complete exemption of small businesses from the nondiscrimination rules, the Administration urges Congress to consider proposals that would enable small businesses to comply more easily with the nondiscrimination rules. If new nondiscrimination rules applicable to health benefits are based on cost of coverage, the Administration suggests that Congress consider permitting small businesses to satisfy the nondiscrimination rules under alternative tests. For this purpose, a small business generally would be defined as a business that cannot purchase health insurance at group rates. The Secretary of the Treasury would have the flexibility of further defining this concept through regulations.

We have offered for consideration this alternative. The dollar limitations on the employee-paid portion of the premium would not apply if: (i) a small business has only one health plan; (ii) the small business makes core health coverage available to 90 percent of its nonhighly compensated employees; and (iii) a majority of the nonexcludable, nonhighly compensated employees eligible to participate in the plan actually do so.

In addition, many small businesses have insurance contracts that do not provide coverage for employees working less than 30 hours per week. The Administration believes that any new legislation requiring employers with such contracts to make available health coverage to employees working less than 30 hours per week should not be effective with respect to such employees until the expiration of the current contract term.

B. Types of Plans Covered by Section 89 Nondiscrimination Rules.

One of the purposes of section 89 was to subject various employee benefits to "uniform" nondiscrimination rules. In practice, this undertaking has turned out to be misconceived.

Thus, the Administration endorses the provision of H.R. 1864 that provides group-term life insurance should be tested for discrimination under a different set of rules than those applied to health benefits. The income exclusion for group-term life insurance is limited by section 79 to the cost of $50,000 of such insurance; complex nondiscrimination rules do not seem appropriate for such a limited tax benefit. Consequently, we support a return to the pre-1986 Act rules applicable to such plans.

C. Qualification Requirements.

Under section 89(k), a plan covered by the statute must meet five so-called "qualification rules": the plan must be in writing; employees' rights must be enforceable; eligible employees must be given notice of their benefits; the plan must be maintained for the exclusive benefit of employees; and the employer must intend that the plan be maintained indefinitely.

1. Covered Plans. Congress should consider applying the qualification requirements only to health plans and, if group-term life insurance is subject to the same nondiscrimination rules as health plans, group-term life insurance. It is questionable whether the tax law's qualification rules are appropriate for all plans currently covered by these rules.

Under prior law, dependent care assistance programs were required to be in writing and reasonable notification of the benefits available under the program was required to be given to eligible employees. These rules are sufficient to protect the interests of employees and the Administration recommends that these provisions be re-enacted rather than subjecting dependent care assistance programs to the qualification requirements of section 89.

Moreover, the qualification requirements appear to be unnecessary for no-additional-cost fringe benefits, employee discounts and employer-provided eating facilities. It is questionable, for example, whether employers should be required to maintain an employee discount program for an indefinite period of time or that an eating facility should be maintained for the exclusive benefit of employees. These fringe benefits are adequately addressed in section 132 and the regulations thereunder.

2. Sanctions for Failure to Meet Qualification Requirements. The current sanction for failure to comply with the qualification requirements of section 89 is the inclusion in employees' incomes of the values of the benefits received under the plan. H.R. 1864 would replace this sanction with an excise tax on the employer equal to 34 percent of the amount paid or incurred under the plan. The Administration agrees with the sponsors of H.R. 1864 that the sanction for failure to comply with these requirements should be imposed on the employer causing the failure, not on employees.

Nevertheless, we perceive two problems with the proposed excise tax. First, it should not be applied to amounts paid or incurred under the plan. Such a provision would require an employer to know all of the health benefits provided under the plan to its employees during each year and the value of each benefit. The Administration recommends that the base to which the excise tax would apply be the cost to the employer of providing the health coverage.

Second, we believe that a 34 percent excise tax may be too high. Consideration should be given a two-tiered excise tax similar to the two-tiered excise tax imposed on certain transactions involving private foundations. Thus, a lower rate excise tax would be applied for each year in which the failure exists. If an employer did not correct the failure within a reasonable time after the failure is discovered, a higher excise tax would apply.

In addition, an employer may inadvertently fail to comply with one of the qualification requirements. For example, the employer may fail to provide a small number of its employees with the required notice of material plan terms. For this reason, any legislation that may be enacted should provide rules for de minimus failures or should give the Secretary of the Treasury authority to provide for such rules in regulations.

CONCLUSION

Although the Administration supports nondiscrimination rules to employer-provided health benefits, the rules of section 89 are, in some cases, too complex and, in other cases, too harsh. There is now a consensus that section 89 must be replaced, and the Treasury Department looks forward to working with this Committee and the Committee on Ways and Means to fashion legislation that addresses the major concerns of employers while serving the basic tax policy objectives of the nondiscrimination rules.

This concludes my prepared remarks. I would be pleased to respond to your questions.

COMMUNICATIONS

STATEMENT OF THE AMERICAN BANKERS ASSOCIATION

The American Bankers Association is pleased to have this opportunity to submit a statement on Section 89 of the Internal Revenue Code and its impact on the banking industry. The American Bankers Association (ABA) membership ranges in size from the smallest to the very largest banks, with 85% of our members having assets of less than $100 million. The combined assets of our members comprise about 95% of the total assets of the commercial banking industry.

Beginning this year, virtually all employers will be required to bring their group term life insurance, health and other welfare benefits plans into compliance with the complex requirements imposed under Section 89 of the Internal Revenue Code. The goal of Section 89, a new Section of the Tax Code added as a result of the Tax Reform Act of 1986, is to insure that benefits programs are provided on a nondiscriminatory basis to all employees. Further expansion of the nondiscrimination "test" was provided as a part of the Technical and Miscellaneous Revenue Act of 1988. IRS regulations released on March 7, 1989 added another level of complexity to the tests. On May 1, 1989, Secretary of the Treasury, Nicholas Brady, ordered a delay in the July 1, 1989 effective date of the regulations until October of this year.

The requirements of Section 89 are separated into two sets of rules: those relating to the qualification standards and those relating to the new nondiscrimination rules. In addition to five basic qualification rules for Section 89, every benefit plan must pass an additional complex set of mechanical nondiscrimination tests. The nondiscrimination rules of Section 89 are comprehensive and could have a dramatic effect on an employee's tax liability and also on an employer's benefit costs.

Because of the complexity of the rules and the amount and variety of the information required to comply with Section 89, employers sought legislative relief from compliance with Section 89. Responding to a clamor for relief from the business community, several bills were introduced to repeal, delay or amend Section 89. Several bills have been introduced in the Senate and House of Representatives.

The ABA applauds the Chairman and members of the Senate Finance Committee on undertaking efforts to provide a simplified alternative to Section 89. ABA is concerned that this overly-complex law will negatively affect the ability of business to expand health benefits to their full workforce.

We believe that new legislation to simplify Section 89 is a step in the right direction. As this committee considers the various proposals, there are some concerns that we believe should be resolved. Our statement addresses these points. We urge all Members of this Committee to include several specific provisions which will enable businesses to better comply with Section 89. ABA recommends that final legislation on Section 89 contain the following provisions:

- That part-time employees be redefined as employees working 30 hours a week for testing purposes.
- Exclusion and separate testing of certain categories of employees in applying the nondiscrimination tests.
- That the effective date for compliance with Section 89 be changed from January 1, 1989 to 12 months after issuance of final regulations.
- That employers be given the option of using either present law or the new rules for compliance for 1989 and 1990. That legislation on Section 89 contain a requirement that Treasury not enforce current regulations on Section 89 pending legislative action. (While Treasury postponed the effective date of current regulations for three months, from July 1, 1989 to October 1, 1989, it could be considerably longer before new legislation is drafted and new regulations promulgated).

Employers have traditionally been free to design health and group life insurance plans that reflect the size and needs of their workforce, their geographic location and the requirements of the industry to retain employees. Consequently, employer-sponsored health plans have flourished and more employees are covered than ever before. The goal of Section 89 was to provide health care for the estimated 30–40 million Americans who are otherwise unable to afford health care coverage. However, in implementation, it has proven too complex to administer. It has had a negative impact on businesses that offer employer-sponsored health and welfare benefits.

For example, some banks have considered cutting back or dropping employer-sponsored health plans. A community bank in Waseca, Minnesota, with assets of $51 million is located in a rural community and has a staff of approximately 23, including the janitorial staff. This community bank is in the process of making the difficult decision of whether to spend a considerable amount of money to test their plans under Section 89, or to drop their benefit plans for all employees and to boost the income of each employee to enable employees of the bank to buy their own health insurance. The bank's management is concerned that the employees may choose to use this "bonus" for purposes other than the purchase of health insurance. This bank is just one community bank in the country, but it is representative of the hundreds of community banks facing the difficult issue of compliance with Section 89 as it is currently written. They simply do not have the funds to hire experts in the health field, attorneys to interpret the emerging law or insurance experts to administer plans.

90 PERCENT ELIGIBILITY TEST AND THE SEPARATE TESTING OF EXCLUDED EMPLOYEES

The principal complicating feature of Section 89 today is the numerous percentage tests for eligibility and benefits which the employer must meet to avoid the income tax sanctions.

Currently, Section 89 states that certain employees can be tested separately to determine if the employer's plan is in compliance with Section 89 generally. This "separate testing rule" was contained in the original legislation to mitigate the harsh effect of the all-or-nothing exclusion in Section 89 for certain groups of employees, i.e. part-time employees, those not completing six months of service or employees under age 21.

One approach for legislation to simplify Section 89 compliance is to substitute the numerous nondiscrimination tests with one test requiring that 90 percent of all non-highly compensated employees be eligible for core coverage. ABA recognizes that such an approach is an improvement. However, the "separate testing rule" must be maintained. The separate testing rule is necessary because it allows the nondiscrimination rules to be met while providing coverage for all full-time employees and some part-time employees as well.

The 90% threshold, when combined with the elimination of the "separate testing rule," makes it virtually impossible for employers that offer broad-based health plans to meet such a high standard.

For example, assume that a bank has 84% of their full-time salaried employees whom are eligible for health insurance coverage; 11% of their employees work 17½ hours or less and are ineligible for benefits; and 5% work less than 17½ hours but receive health benefits under the employer-sponsored plan. If this bank tested their benefit plan under Section 89 today, which has the "separate testing rule," this bank would pass the nondiscrimination test. It can only do so because it is allowed to exclude from the testing pool employees that work 17½ hours or less and who are otherwise ineligible for health coverage. But if the "separate testing rule" were to be eliminated from Section 89 testing, the bank would fail the 90 percent eligibility test. Under such legislation, of the employees eligible to receive employer-sponsored benefits, only 89% would be eligible for coverage (84% + 5% = 89%) falling just short of the 90% threshold. Some of the banks have this exact problem.

Without retention of the "separate testing rule," an employer who might otherwise satisfy the 90% eligibility test, might be motivated to reduce the number of eligible employees in an attempt to meet the 90% nondiscrimination test. One method to lower the number of eligible employees is to drop employer-provided benefits for part-time or probationary employees. We urge that any legislation introduced to amend Section 89 contain the "separate testing rule." Without it, any bill introduced would only discourage employers who provide above average fringe benefit programs for all employees.

PART-TIME EMPLOYEES

Under Section 89 today, part-time employees, defined as working up to 17.5 hours, must be included in calculations for discrimination testing. Several bills currently introduced propose to change the definition of a part-time employee to 25 hours. This change helps, but it still ignores the current market realities in health care and small business in which the definition of part-time employment is a 30 hour work week. In addition, benefits available to employees reflect regional or geographic practices. In many parts of the country, insurance companies will not sell health insurance for employees who work less than 30 hours per week. We believe that redefining part-time employees to those working 30 hours is more appropriate.

EFFECTIVE DATE

Implementation of any changes to Section 89 should be delayed, at a minimum, for at least 12 months after enactment. Additional time is necessary to allow businesses time to redesign plans in order to pass the Section 89 test. The process of testing all plans, redesigning plans to comply with Section 89 nondiscrimination rules, followed by retesting, will take months to effectuate. Delaying the effective date of Section 89's nondiscrimination testing to 12 months after final regulations are promulgated by IRS will provide businesses the necessary time to comply with Section 89. In addition, we urge Members of the Ways and Means Committee to sponsor and support legislative initiatives requiring that Treasury withdraw the proposed regulations on Section 89 until legislative relief is provided by Congress. It is counterproductive to pay consultants' fees and programming costs to comply with Section 89 only to have the law extensively modified months later.

CONCLUSION

The banking industry is committed to providing adequate and uniform health and insurance coverage for their employees. We agree that, as a matter of public policy, employees should receive equitable benefits. However, because Section 89 is extremely complex, and because the regulations are an administrative nightmare, it has become a tremendous disincentive for employers who maintain health and life insurance for their employees. Many consultants are recommending that employers terminate their health and life insurance plans, give their employees a bonus, and simply have employees buy health coverage on their own. On costs, the Kansas Bankers Association has estimated that the cost to Kansas banks of compliance with Section 89 and the current regulations would be nearly one-half million dollars.

Making compliance easier is an important direction for Congress to proceed in developing alternatives to Section 89's requirements. However, the provisions of current legislation that impact on Section 89 do not go far enough in providing the needed relief business requires to make certain that disincentives do not persist for the provision of health and insurance coverage to employees. Public policy must be pursued in ways that acknowledge the limitations of the business community and their ability to comply. To that end, ABA has supported repeal of Section 89 because we see little benefit to phasing in rules which will only lead to costly adjustments.

Unless significant improvements can be made in the design of these requirements to minimize the complexity and paperwork burden of subsequent regulations, Congress should still consider repealing Section 89 and starting over.

STATEMENT OF THE AMERICAN BUS ASSOCIATION (SUBMITTED BY SUSAN PERRY, VICE PRESIDENT FOR GOVERNMENT RELATIONS)

Mr. Chairman, and members of the Committee, my name is Susan Perry and I am the Vice President for Government Relations for the American Bus Association. On behalf of our 700 members operating bus companies in all fifty states, I would like to thank you for this opportunity to comment on section 89.

Our members understand and endorse the concepts behind section 89, those of non-discrimination rules for benefit plans. However, they have encountered serious problems in their implementation no matter how agreeable the rules may be in theory. We understand that the current section 89 format was chosen in an attempt to provide fair treatment to employers under a broad variety of circumstances, but its myriad of options render it almost indecipherable.

While I will refrain from repeating the litany of problems that small business has encountered with section 89, the nature of our compliance problems is as follows:

—The number of tests and their application is confusing to our members.

—Employers noted similarities between section 89 requirements and those incorporated in the Department of Labor's ERISA standards, and assumed that they were identical.

—The comprehensive data collection requirements exceeded the amount of time and equipment that our members can practically devote to operating an employee benefits plan.

—The lack of specific guidance and definitions on a number of issues led employers to believe that compliance was only possible with the assistance of special section 89 advisors.

In short, section 89 is acting as a disincentive for employers to provide their employees with benefit plans.

Consequently, Mr. Chairman, we enthusiastically welcome the Committee's participation on this issue. Among the many proposals for dealing with section 89, we would like to direct your attention to the following provisions that we believe should be included in modification legislation:

—A Single Simplified Test: Create a testing mechanism that the employers themselves can realistically be expected to administer. By replacing the multiple test system with a single test, confusion over test choices is eliminated.

—Reduced Data Collection: Current Section 89 regulations place an inappropriately heavy information gathering burden upon the employer. We urge you to trim these requirements, effectively cutting the number of administrator hours necessary for compliance.

—One-Day-a-Year-Testing: Current law appears to assume that an employer is guilty of discrimination until they have affirmatively proven their innocence. Documenting the thousands of changes that occur within plan administration annually is unnecessary and creates administrative difficulties. Changing to a one day testing period would acknowledges good faith on the part of the employer and reduce the need for sophisticated data processing equipment.

—Study the impact of Section 89 on Small Business: Many observers have commented on the need for flexible application of non-discrimination rules to small businesses. Given their limited operating budgets, small staffs, and lack of sophisticated equipment, we feel that there may be the need for additional simplification of the rules for small businesses. An exemption for firms employing twenty workers or fewer, as recently mentioned, may be the correct route to follow. While no-one has all of the data on this issue, we would like to encourage and participate in a dialogue on this with the Committee.

—Study the Feasibility of Moving Compliance Requirements to Higher Levels in the Distribution Chain: Currently, Section 89 administration centers around data collection and audit at the least centralized, least technically sophisticated level of distribution: the employer. Importantly, the employer is not in business to offer employee benefit plans.

The plan vendor, however, maintains large data banks and computerized systems that administer thousands of plans every day. It would seem much easier to require the vendor to package benefits within a "pre-approved" software format. Employers could then purchase benefit plans assured that, as long as their choices conformed to the plan's parameters, they were automatically in compliance. Any choices made by the employer that resulted in discriminatory excess would generate a computerized "flag" from the vendor's computer. The employer could then be notified, declare the excess and paying the tax, or modify their choice to conform to the rules.

—Raise the Part-Time Employee Coverage Threshold: The current part-time employee coverage threshold is 17.5 hours per week. Raising this number from 17.5 to 30 hours per week would both make it uniform with other Federal standards and more closely mirror our members' feelings as to when employees should receive benefit coverage. Importantly, acceptance of part-time employment, by definition, is an implicit decision to forego the compensation and benefits received from full-time employment in favor of some other benefit. Employers should not be required to compensate part-time employees who work less than 30 hours per week at the same level as full-time employees.

—Adjust Section 89 Rules to Conform with ERISA Where Applicable: As Government oversight in the workplace becomes more comprehensive, employers become confused with conflicting standards. To prevent inadvertent compliance difficulties, every effort should be made to make parallel regulations identical.

—Allow Cafeteria Plans: Under current Section 89 law, employers are allowed to take advantage of a flexible benefits mechanism known as a "cafeteria plan." Many employers use such plans to allow their employees to better satisfy their individual needs by picking those benefits most desirable. We understand many of these plans

would not comply with the language included in several new proposals. Where appropriate, provision should be made to allow such plans.

Again, Mr. Chairman, I would like to express our thanks for your willingness to work with us to generate a proposal that is fair to all. While fairness and simplicity often seem to be competing priorities in tax legislation, we feel that careful simplification would satisfy both of these criteria. Please accept our support for your efforts and our participation in a continuing dialogue on this issue. Thank you.

AMERICAN FARM BUREAU FEDERATION

Hon. LLOYD BENTSEN,
Chairman, Senate Finance Committee,
Washington, DC.

Dear Mr. Chairman: The Committee recently held a hearing on efforts to simplify Section 89, and Farm Bureau submits this letter to you for inclusion in the hearing record.

Section 89 is a provision in the Tax Reform Act of 1986 which has caused much concern and expense among employers since it went into effect on January 1, 1989. Because of its potential effect on Farm Bureau members who are agricultural employers and on the American Farm Bureau Federation, the 50 State Farm Bureaus, 2,800 County Farm Bureaus, and Farm Bureau-affiliated companies, the AFBF Board of Directors adopted a position at its March meeting to support repeal of Section 89.

Presumably this provision was included in the Tax Reform Act to encourage employers to provide insurance coverage for all employees, not just those who are highly compensated. While the intent of Section 89 to discourage discrimination between highly compensated employees and lower compensated employees may be commendable, the complexities and costs involved for both farm and non-farm employers to determine and maintain plan compliance can be prohibitive. In fact, we are aware of farmers who have dropped health care coverage for their employees altogether because of Section 89. It is unfortunate that Section 89 is having the opposite result of its intention.

Farm Bureau believes that efforts of simplification, delay, and exemptions are ultimately unproductive and that repeal is the best answer. We support this position and ask that it be duly noted in the hearing record.

Thank you for your consideration of our view.

Sincerely,

JOHN C. DATT, *Executive Director,*
Washington Office.

STATEMENT OF THE AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS

The AFL–CIO is pleased to have this opportunity to share its views with the Committee on the simplification of Section 89 of the Internal Revenue Code, and S. 654, the Section 89 Simplification Act. Organized labor has long supported the intent of the original Section 89 provision to prevent employers from offering tax-subsidized benefits to executives, while providing little or no benefits to lower wage employees. Nonetheless, the complexity of the provision, its burdensome record-keeping procedures, and the delay on the part of the IRS in issuing regulatory guidelines has created an administrative nightmare for labor and management benefits managers. Section 89 also has proved to be a boon to private benefits consultants, whose fees get passed on to beneficiaries in the form of higher costs or lower benefits.

We are pleased, therefore, to lend our support to efforts to replace the current provision with a simple and fair antidiscrimination test designed to expose discriminatory practices, without placing undue burdens on companies that are providing decent benefits. We applaud efforts to streamline the testing process by allowing employers to look at the design of a benefit plan to determine whether it is in compliance with the proposed requirements. However, we strongly recommend that the committee not create another safe harbor but replace current law with a new, streamlined non-discrimination test.

While we share the view that reasonable limitations on employee cost-sharing will make it possible for working families to participate in benefits plans, we have strong reservations about whether S. 654 as currently drafted will accomplish this objective. Accordingly, we would like to offer suggestions for changes in the follow-

ing areas: (1) expanding the benefit design test; (2) adding a provision that limits the difference in the value of benefits provided to non-highly and highly compensated employees; (3) coverage of part-time workers; (4) treatment of multi-employer plans; and (5) employer penalties for non-compliance with qualification requirements.

EXPANDING THE BENEFIT DESIGN TEST

As the committee is aware, insurance premiums for health care benefits are developed by projecting inflation, utilization, changes in a group's demographic composition and new technological developments. Geographic location and size of firm also play important roles in determining the final premium price. Therefore, the cost of a specific package of benefits can vary widely, from employer to employer around the country.

A recent report, *Health Policy Agenda for the American People (HPA)* reinforces this point. In that study, actuaries estimated the cost of a basic benefit package of inpatient and outpatient hospital care, physician services, X-ray and laboratory procedures, and limited mental health care services to range from $1,300 to $2,800 per employee per year. These figures are composite rates based on a projected mix of single employees and families in one of five prototype groups located in various parts of the country.

The AFL–CIO is concerned that without exceeding the premium-sharing limitations in the bill, an employer located in a high cost area, in a small firm, in an uncompetitive market, or those that want to limit their health care contributions could pass on additional costs to employees in the form of higher deductibles and coinsurance. If the committee's objective is to make health care benefits more affordable so that working families can take advantage of plans offered through their employers, it should also place limits on other out-of-pocket payments, such as deductibles, copayments and stop-loss provisions.

Specifically, we would propose that: (1) deductibles be limited to $250 for individuals and $500 for families; (2) coinsurance be limited to 20 percent; and (3) there be an overall cap of $3,000 on total out-of-pocket expenses. Otherwise, implementation of the proposed provision could invite the type of benefit inequities that gave rise to the original Section 89 provision.

We urge you to consider reducing the level of premium sharing that would be permissible. We propose that the committee consider reducing the premium levels to $3.27 for individuals and $8.30 for families, which were derived by taking 20 percent of the cost of a low option benefit plan. Another and perhaps more preferable alternative would be to limit employee premium sharing to 20 percent with an overall cap on employee payments.

It should be noted that our proposed changes would by no means guarantee a so-called "Cadillac" plan. In fact, the Wyatt Company's recently released 1988 group benefits survey shows that for basic health plans with major medical coverage, 76 percent require deductibles of $100 or less. A full 81 percent require premium sharing of less than $75 per month, with one-third in the sample requiring premium contributions of $25–$49 per month, and 32 percent requiring premium sharing of less than $25 per month. Similar information has been reported by the Department of Labor. In its 1986 survey of medium and large firms employee premium sharing for individual and family coverage averaged $13 and $41 a month, respectively. Adjusting for inflation would produce current figures that are similar to those reported by Wyatt.

CAPPING THE PERMISSIBLE DIFFERENCE IN VALUE OF BENEFITS PROVIDED TO HIGHLY AND NON-HIGHLY COMPENSATED EMPLOYEES

The AFL–CIO would like to express its support for a provision extending to all employees that would place a cap on the difference between the value of benefits provided to highly compensated employees and non-highly compensated employees. We propose that you consider limiting the allowable difference in premium value between the highly and non-highly compensated groups to 120 percent. While legislation introduced in the House proposes a cap of 133 percent, in our view, this figure is much too high.

For example, if $200 were the value of the premium for the non-highly compensated employees, the premium for the highly compensated employees could not exceed $266. Turning again to the Health Policy Agenda data, for four out of the five employer groups modeled, this $66 difference in premiums would allow the highly compensated employees to have additional benefits that include a basic dental plan, wellness programs, well-baby care, physical and occupational therapy, skilled nursing home care and home care. Another study by Gail Jensen of the Uni-

versity of Illinois at Chicago and Michael Morrisey of the University of Alabama at Birmingham provides similar results.

We do not believe that Congress intends to encourage such a dramatic difference in benefit availability. We could propose, therefore, that you consider limiting the allowable difference in premium value of plans for highly and non-highly compensated employees to 120 percent.

COVERAGE OF PART-TIME WORKERS

It has been proposed that the hourly requirement for Section 89 testing be raised from 17.5 hours to 25 hours. Since 1980 the number of part-time workers has increased by 40 percent. Currently, 20 million individuals work part-time, 50 percent of those work 20 hours or more per week. We are concerned that unless employees who work 20 hours or more per week are included in the nondiscrimination tests, more than one-half of them will continue to go without needed health care protection. In our view, this is particularly inappropriate in the service industry where part-time employees are an integral part of the work force.

Another issue of concern to the AFL–CIO involves situations where there is a two tiered benefits structure for part-time and full-time workers. In some industries unions have been able to negotiate benefits for all part-timers, but they may not be equivalent to benefits provided to full-time workers, which may prevent the plan from meeting the Section 89 test. Therefore, the AFL–CIO would propose that the committee exempt from the definition of highly compensated employed workers covered under collective bargaining agreements.

EMPLOYER PENALTY FOR NON-COMPLIANCE WITH QUALIFICATION REQUIREMENTS

The AFL–CIO fully supports the committee's proposal to place a penalty on employees who work for employers who do not comply with the qualification requirements in the legislation. We agree that the current provision is unfair but would not address the problem by penalizing highly compensated employees. Instead, we would impose penalties on employers who have exclusive control over the design of plans.

MULTI-EMPLOYER PLANS

In our view, any Section 89 simplification plan must retain the concept now in current law of the employer contribution being equivalent to the benefit being provided. In our view, however, a special rule may be needed for industries where employer contributions for benefits are a percentage of pay, while the benefits are standard for all individuals in the bargaining unit. Also, monthly or similar equivalents will be needed to correspond to weekly hourly requirements. Again, we are prepared to work with your staff to address the special needs of multi-employer plans.

We hope that these suggestions are useful to the committee. We look forward to working with you and your staff to resolve these important issues.

STATEMENT OF ASSOCIATED BUILDERS AND CONTRACTORS

Associated Builders and Contractors is pleased to comment on section 89 and the proposed changes to the Internal Revenue Code. ABC represents a diversified group of 20,000 contractors, subcontractors and suppliers united by the Merit Shop philosophy of management—encouraging a competitive environment in the construction marketplace. ABC's membership is dominated by small businesses—over 80 percent of ABC's members fall under the Small Business Administration's definition of a small business.

Mr. Chairman, ABC is encouraged that you have called for "major surgery" on section 89. However, it is our clinical opinion that the patient is already dead. ABC believes that only repeal of section 89 will reverse the current disincentives to health care coverage. Over 330 members of Congress feel the same way. These provisions are so flawed that it would be best to start with a clean slate. If Congress then chooses to address the merits of section 89, so be it. Even with the compliance delays set by Treasury, our members are left wondering when, what version, and if they will have to comply with section 89.

The construction industry already suffers from a severe shortage of skilled labor in many areas of the country. ABC recognizes that to attract skilled craftsmen and women to our industry, we must make health care and other employee benefits more readily available to a more mobile and diverse labor pool. Yet, the net effect of

section 89 is to force many contractors to stop supplying any health benefits, and discourage those that were planning to, from ever starting. It is indeed ironic that these employers are most hurt by the current law and regulations.

ABC agrees with the goal of an equitable distribution of health care benefits. However, there has been no evidence or study that shows discrimination in benefits is a pervasive problem. As the Small Business Administration has pointed out, the perception that small firms tend to discriminate in the provision of health benefits is not true. Although about three quarters of all the noninsured work for small firms, studies show that small firms with health insurance more frequently offer coverage to all their employees than do large firms.

If they cannot, it is usually not because they don't want to, but because of low operating margins, or in the case of construction, the transient nature of the workforce makes it difficult for employers to obtain affordable coverage.

Indeed, it is affordability and access that are the keys to the formation of small business health insurance plans. How contractors offer health benefits is controlled by the necessity of delivering a broad group to the insurance carrier. It is not discrimination, but the failure of tax policy to address employer-provided health care, which prevents total employee coverage.

ABC does appreciate the efforts made in the Senate to address section 89. Unfortunately, neither S. 654 nor S. 595 deal sufficiently with the existing framework of rules for nondiscrimination or the increased costs imposed.

Because the present focus of discussion, besides repeal, has centered on H.R. 1864, we will direct our concerns to this bill's provisions. H.R. 1864 is a significant improvement over current section 89. Substituting a design-based test for several participation-based tests is a considerable simplification. Figuring employee and employer tax status is more predictable, and compliance in general is less complicated and expensive.

Notwithstanding these substantial improvements, there are a number of concerns and recommendations ABC would like to make to H.R. 1864. We must emphasize that if these problems are not rectified, we will have no choice but to continue to support repeal of section 89.

RECOMMENDATIONS

Small Business Exemption

First, embrace the Administration's suggestion that a small business exemption from compliance with section 89 be adopted. Smaller construction firms and small employers in general are disadvantaged by the imposition of complex and costly compliance measures added to escalating health care costs. Confronted with a severely complex legal maze and an unstable insurance market will limit their exposure to such a market by restricting or withdrawing employer-sponsored coverage.

Employee Contribution

ABC is concerned with the maximum employee contribution ($10 per individual per week, $25 per family, indexed to average wage growth) Requiring a greater employer contribution will cause more contractors to cut benefits entirely, or drive them out of business. If such a provision does prevail, we would rather see achievement of affordability through the establishment of minimum employer contributions based on a percentage of wage basis or a cost-based index. A uniform dollar figure ignores regional differences in wages and insurance costs. Moreover, with health insurance costs spiraling contribution figures, reasonable today will be unrealistic within two years.

Such an arbitrary and inflexible employee contribution ceiling will discourage contractors from providing health insurance, especially family coverage. The reason is that mandating a limit on the employee share creates a "cost cliff." Under pre-Section 89 law, many contractors phased in health coverage. As profits grew, it expanded coverage and absorbed additional costs. Senate reform bills have even lower contribution levels, preventing even more contractors from affording health coverage.

The contractor-owner is unlikely to make a substantial commitment until confident that the company can handle the costs. He or she may begin by contributing 20 or 50 percent for family coverage, but the opportunity to secure coverage is there. As mentioned above, over time, the contractor's contribution increases. H.R. 1864 prevents such flexibility and makes coverage an "all or nothing" proposition. Fixed dollar limits only delay coverage as the owner is unable to pay the bulk of health insurance costs until the firm's profitability makes it affordable.

Leased Employees

A critical concern relates to the difficulties involved in determining qualification rules for leased employees under H.R. 1864. The bill does provide a leased employee safe harbor rule similar to the rules for qualified pension plans. An employer may disregard a leased employee if the leasing company certifies that the employee has available a core health plan meeting the limitations on employee contributions. This rule applies only if less than 20 percent of the non-highly compensated workforce are leased employees.

ABC and others in the construction industry are concerned that new IRS proposed regulations (26 CFR Part 1, March 7, 1989) would define leased employees so broadly that independent contractors and subcontractors would be treated as leasing organizations. This interpretation goes way beyond Congress' intent when it passed IRC section 414(n) to prevent employee leasing rules from being abused. The regulations would require a subcontractor's employees to be treated as employees of the general contractor for benefit plan purposes. In fact, project owners at the top of the chain would have to pay benefits for the employees of the general contractor as well as the subcontractors.

It's important to emphasize that independent contractors and subcontractors are independent businesses that provide health benefits to their own employees. There may be over 50 of these subcontracting companies on one site during the life of a contract. If subcontractors are declared leasing organizations, then greater than 20 percent of the workforce would be regarded as leased employees and the safe harbor rules would not apply. Under the following very real scenarios, the contractor is placed in a no-win situation.

If for qualification purposes employees of subcontractors are treated as the general contractor's employees, then the subcontractor's employees will have to be notified of the general contractor's health plans. Should the subcontractor's employees not be treated as employees of the general contractor, then including them as subcontractors may cause the plan to fail section 89 because the plans are not for the exclusive benefit of employees.

The general contractor is responsible for all of the compliance requirements, an untenable burden—especially when considering the multiple subcontractors he or she may have to work with. Consider that if the contractor does not supply notification of the plans to the subcontractors, he may fail the qualification tests if the IRS later deems it necessary. All information for compliance testing must be gathered by the contractor. The same holds true for subcontractors who may have contractual arrangements with second and third tier subcontractors. And, there is no mechanism for ensuring that the actual employer, i.e., the subcontractors in most cases, supply the necessary information to their on-site employees.

Clearly the definition of "leased employee" needs to be simplified and clarified further by Congress for the IRS, especially given the severe tax penalties imposed on employers failing the qualification tests. One possibility is to reexamine the safe harbor rules. If employees are receiving core health coverage, the provider should be irrelevant. *For section 89 purposes the leased employee provision should be deleted entirely. Anything less will create a web of complexity that is totally unworkable for contractors and subcontractors.*

Implications for Construction and the Davis-Bacon Act

The unique nature of the construction industry employment must be considered when establishing section 89 guidelines. To start, reconciling the Davis-Bacon Act requirements with those in H.R. 1864; Davis-Bacon requires that the prevailing wages and fringe benefits be paid to hourly construction laborers on federally and federally-assisted construction projects. The Act applies to union and non-union workers. H.R. 1864 would have the effect of taxing benefits that another federal statute requires employers to pay.

The Department of Labor assesses local conditions to determine what wages and fringe benefits (health insurance) prevail in states, cities and counties. They then issue a general wage determination decision that specifies in dollars and cents the minimum amounts to be paid by contractors and subcontractors to laborers. The Davis-Bacon Act requirements may be satisfied if the employee receives the entire amount—both wages and fringe benefits—immediately in cash. If the employers provide health or retirement benefits instead of cash, stringent requirements must be met.

If the employers satisfy Davis-Bacon requirements by paying benefits in cash, the method of payment would not satisfy H.R. 1864 as presently written. The employer would have to provide two sets of benefits to satisfy the two statutes. Under Davis-

Bacon, there must be the option to pay cash to satisfy the employers obligation to pay cash due to the requirements of the Act.

Suppose the employer applies the Davis-Bacon fringe benefit amounts to pay for health insurance. The employer would provide core health coverage to a large number of hourly workers. Construction workers leave and come back several times a year to the same employer. Imagine the burden of trying to keep track of so many workers' benefit circumstances to determine if you are in compliance with H.R. 1864, even though you're already paying federally mandated benefits.

Also, since Davis-Bacon amounts may not be used to fund benefits not related to Davis-Bacon work, the employer may be faced with calculating what portion of health benefits should be paid with Davis-Bacon funds. This gets terribly difficult if a craftsman is working for one employer at multiple job sites, some Davis-Bacon, and some not.

The imposition of a prevailing wage is somewhat analogous to the collective-bargaining process. A federal statute takes the place of the negotiated agreements or employer wage rates. Indeed, Davis-Bacon applies to both union and non-union employers. The Labor Department determines the wage and fringe benefit rates for all federal and federally-assisted construction. A federal statute should be given at least the same status as a negotiated contract. Davis-Bacon amounts and workers should be given the same status as collectively-bargained agreements and workers.

Part-Time Employees

Although H.R. 1864 has improved the threshold to 25 hours per week for part-time workers to be considered for purposes of section 89 testing, it needs to be raised to at least 30 hours per week. We have found that in many parts of the country insurance companies will not sell health policies for employees working less than 30 hours per week.

The construction industry is especially sensitive to abuses in this area. Members have gotten stuck in the past with paying for the benefits of family members of employees who put in the minimum required hours, and then soon leave the firm. This provision raises real problems of adverse selection and affordability of the plan to all workers. Insurance companies know that part-time workers are generally greater health risks, and either do not permit them to participate in group health plans or raise rates accordingly. A higher threshold is more in step with economic realties—any less and contractors are likely to reduce the amount of part time work available.

The 133 Percent Solution?

The taxation of benefits for highly compensated individuals in current section 89 occurs when average benefits exceed 133 percent of rank and file benefits. However, in this bill, the test is much more severe because instead of looking at average benefits of both the highly and non-highly compensated, H.R. 1864 compares what each highly compensated employee receives to the lowest benefit that is taken into account in passing the 90 percent test. This is unnecessarily harsh. Thus comparative averages is a more realistic test.

This provision is quite clearly a "back-door" tax on employee benefits. If pursuing such a tax policy is the Committee's goal, then ABC would rather see it debated separately on its own merits—not as an adjunct to section 89. The issue is far too important to be considered in any other manner.

90 Percent Eligibility

The requirement that 90 percent of all non-highly compensated employees be eligible for coverage is a test for universal coverage, not discrimination. It is especially restrictive for construction insurance purposes because insurance carriers often refuse to cover some individuals because of preexisting conditions or other underwriting practices.

The nature of construction employment also makes this provision very difficult to comply with. Construction jobsites and hence workforces shift constantly. A craftsman may work on one stage of construction, and then move on to another employer as another set of workers with different specialties begins work. That's why the industry's turnover rate is over 300 percent.

Maintaining compliance under such conditions may force a transient workforce and would be next to impossible should the IRS define "leased" employee unfavorably and deem these workers as employees, not as subcontractors' employees. In addition, with a 25 hour per week part-time threshold you are including more workers who may not provide the firm with the extra value sufficient to warrant insurance coverage.

A large portion of our member firms have less than 20 full- time employees. Construction work is completed by a combination of the general, or prime, contractor and a variety of individual subcontractor companies. All are considered employers and have individual workforces. In the realm of these small firms, compliance with the 90 percent test could be especially difficult. For example, if a five person firm is to meet the test, 4.5 workers would have to be covered and the only way such a firm could comply is to cover all five employees.

There should be consistency between statutes. ERISA requires 79 percent coverage, and the minimum coverage rules in IRC section 410 require 70 percent coverage in the pension area. The same policies should apply for section 89.

Qualification Tests and the 34 Percent Excise Penalty

A final concern to ABC is H.R. 1864's imposition of a 34 percent excise tax on benefits if the plans do not meet a five-part qualification test. The test requires that each plan must be in writing; the plan must be established for the exclusive benefit of the employees, spouses and dependents; employees must be given reasonable notification of benefits; and it must be maintained for an indefinite period of time. Although these requirements may seem innocent enough, the proposed section 89 regulations themselves are complicated and difficult to understand.

For example, requiring a "recitation of material terms" in the plan description means that virtually every health plan in the country will have to be rewritten. Requiring the plan to be legally enforceable intrudes on the health plan design. The proposed regulations should be amended to make the rules consistent with COBRA and ERISA requirements, which already contain provisions for legally enforceable and reasonable notice provisions.

There is no logical reason for duplicating existing rules and imposing a severe tax penalty on top of remedies already provided for in ERISA. Certainly a 34 percent excise tax should be reduced. Since a 5 percent penalty is invoked under the Internal Revenue Code for underpayment of taxes due to negligence, a similar policy seems fair for an employer who inadvertently fails to amend a plan or take a new feature into account.

As a last comment, ABC is encouraged by the actions taken so far to rectify section 89. Resolving the issues surrounding this matter will take time. In the meantime, action must be taken to quell the more immediate costs of compliance and frustration our members are now experiencing. We would urge you and your colleagues to work with the Secretary of the Treasury to suspend enforcement of the current law until Congress works its will on section 89.

Mr. Chairman, although Congressman Rostenkowski's bill is a more workable bill, it is still fundamentally a costly, burdensome disincentive to employer-provided health insurance and will reverse efforts to expand our Nation's policy goals of expanding coverage.

ABC strongly encourages you to give thorough and thoughtful consideration to the changes we have suggested to section 89 reform. Without it, compliance with section 89 is untenable for our members and the particular circumstances of the construction industry. Thank you.

STATEMENT OF THE ASSOCIATED GENERAL CONTRACTORS OF AMERICA

The Associated General Contractors of America is a construction trade association representing more than 32,500 firms, including 8,000 of America's leading general contracting companies, which are responsible for the employment of more than 3,500,000 individuals. These member construction contractors perform more than 80% of America's contract construction of commercial buildings, highways, industrial and municipal-utilities facilities. Eighty-five percent of AGC's membership has gross receipts of less than $10 million annually; ninety percent qualifies under the Small Business Administration's definition of a small business. AGC appreciates this opportunity to comment on the need to reform Section 89.

AGC urges that, in considering these comments, Congress keep in mind the unique nature of the construction industry, as follows:

- The construction industry produces a unique item with every building, facility or highway constructed. Every blueprint is different; each site varies; conditions for construction vary every day.
- The construction industry does its work at multi-thousands of jobsites, resulting in a largely transient workforce.
- The construction industry's transient workers must regularly move to new sites and normally another employer to continue working.

• A construction worker may leave and come back to the same employer several times in the course of one year, as projects begin, go through the phases of construction and end.

The construction industry, offers a wide variety of health plans to suit the unique needs of hourly workers.

Congress clearly recognizes the serious problems Section 89 poses for every segment of American industry.

• Sen. Steve Symms of Idaho has introduced legislation to delay implementation of Section 89 for one year.

• Sen. David Pryor of Arkansas has introduced legislation to simplify the bill.

• The Senate, on April 12, agreed overwhelmingly to a sense of the Senate amendment that the House should immediately pass and report to the Senate a bill to repeal or reform Section 89.

• Sen. Trent Lott introduced S. 350 to repeal Section 89.

On the House side, Rep. LaFalce's bill to repeal Section 89 has over 280 co-sponsors, and the House Ways and Means Committee is preparing to amend Section 89.

From the perspective of the construction industry alone, Section 89 as it now exists is so badly flawed in so many ways that AGC strongly supports S. 350 and H.R. 634, the bills to repeal the 1986 act changes and return to the pre-1986 nondiscrimination rules. No penalties should be imposed in 1989 for failure to comply because of the many uncertainties surrounding implementation of Section 89.

Section 89 as it now exists does not further Congress' goal of encouraging broader coverage of nonhighly compensated workers. Instead, its complexity and administrative problems force employers to reduce the number of options they offer to employees.

The problem with Section 89 as it exists now is its bewildering complexity. Section 89 requires that every option offered under every plan be valued separately. For each option, every employee must be ranked twice, once under this year's salary and once under last year's salary, to determine how many highly compensated employees participate in that option. Especially for smaller companies, the cost of testing is greater than the cost of providing benefits to employees. Most smaller companies do not have staff in-house with the expertise necessary to perform the complicated testing. They must hire expensive outside consultants.

Companies trying to comply found themselves forced to streamline plans and reduce the options available to employees in order to bring the testing process down to manageable proportions. Plans developed to cover a highly mobile work force in physically demanding jobs are in danger of being terminated for failure to satisfy technical tax rules.

The costs of compiling the initial information with which to begin Section 89 compliance are staggering. Employers must accumulate a significant amount of data regarding each employee and each option under a plan to prove compliance. The information required includes an employee's date of birth, the date of hire, marital status, employment status, number of dependents, annual compensation for this year and the preceding year, the number of hours normally worked in a week, the number of months normally worked in a year, whether employees are eligible members of a collective bargaining unit, benefit options an employee is eligible for, benefit options the employee actually participates in and other coverage on employees, spouses and dependents.

For example, each option under a plan must be valued separately. That means that for each option, each employee must be ranked twice—once under this year's salary and once under last year's—to determine how many highly compensated employees participate in that option. The confusion of an employer faced with calculating all options for all employees approaches chaos.

Congress added the new rules as part of the Tax Reform Act of 1986. Originally, the new law was to become effective for plan years beginning after December 31, 1987, if the IRS issued guidance. In the absence of IRS guidance, the new rules were then to become effective for the earlier of plans years beginning after December 31, 1988. As part of the 1988 tax act, Congress directed the IRS to issue guidance by November 15, 1988. Congress also legislatively prescribed some temporary rules to fill the void.

The IRS did not issue guidance until March 7, 1989. The proposed regulations did not address multiemployer plan issues, lines of business or the valuation question, which is central to the entire concept of Section 89 as it now exists. The regulations that did come out increased the complexity of an already dense statute. Although the regulations postponed implementation of several important sections and added transition rules, the gains from those changes are outweighed by the additional complexities added by the proposed regulations.

The lack of timely guidance from the IRS is the most acute, though not the only, problem facing employers trying to comply with Sec. 89. IRS and Treasury representatives have said that there is sufficient guidance elsewhere in its releases for employers to comply with the new law. If that were correct, then the IRS and Treasury should have found it relatively simple to provide guidance. Instead, there was no official guidance for more than 21/2 years after enactment.

If the IRS and Treasury cannot provide guidance, then employers should not be expected to make up the deficiency. Employers making a good-faith effort to comply may find their determinations overturned on audit. Steep penalties would follow for failure to comply with Section 89.

In addition to the lack of timely guidance on the new law, AGC has identified several specific problem areas.

Plan Qualification requirements. Some of the most acute problems center around the plan qualification requirement. Employers must first satisfy a five-part qualification test for employee benefit plans established under any one of nine different Internal Revenue Code sections. These include group health and accident plans, group term life insurance plans, group legal services plans, educational assistance plans, dependent care assistance plans, tuition reduction plans, cafeteria plans, Sec. 505 plans (including VEBAs) and employee fringe benefits plans.

For each of these plans, the plan must be in writing, the employees' rights must be legally enforceable, employees must be given reasonable notification of benefits, the plan must be established for the exclusive benefit of the employees, spouses and dependents, and the plan must be established with the intention of maintaining it for an indefinite period of time.

These requirements are even more difficult to meet than they sound. The proposed regulations add additional complexity without much gain to the employee and at an increased cost to the employer. The statute should be amended to coordinate the rules with COBRA and ERISA requirements.

For example, the material terms cited by the regulations that must be provided to employees are very close to the requirements for summary plan descriptions prescribed by the Labor Department. Why not have one be the same as the other? The summary plan description is already distributed to plan participants. There is no benefit to the employees in providing two sets of notices. The notice of material changes to the plans must be distributed within 60 days to all eligible individuals. Under ERISA, a summary of plan changes must be distributed within 210 days after the close of the plan year. Again, the proposed regulations impose additional unnecessary and repetitious notice requirements. It is at least an arguable issue whether IRS has the authority to override ERISA requirements.

Those plan documents must be legally enforceable. The employees' rights must be ascertainable from the documents, so that legal remedies can be pursued based on the documents. So those documents must be carefully prepared with that in mind.

Employees must receive reasonable notification of their benefits under the plan. What constitutes reasonable notification? The answer seems to be that every employee must be notified of every benefit under every plan in order to avoid Section 89 penalties. Notification may not be limited to employees who are eligible for a particular benefit. Employees who may become eligible in the future must also be notified.

The plans must be established for the exclusive benefit of employees, their spouses and dependents. There may be a hidden trap in that provision, because of the interaction with the leased employee rules. In 1982, Congress concluded that employees of a "leasing organization" were to be treated as employees of the organization to which they provided services for retirement plan purposes in a number of situations. Congress extended this rule to plans covered by Section 89 as part of the 1986 tax act changes. The IRS published proposed regulations that broadly define a leasing organization far beyond Congress' intent. Some IRS representatives interpret the employee leasing rules to cover the general contractor-subcontractor relationship. On a construction site, one general contractor works with multiple subcontractor companies. For example, on a commercial building site, the general contractor can have up to 75 subcontracting companies on that one site during the life of the contract. The data gathering requirements alone are monumental for all the different subcontractors.

If the subcontractor's employees are to be treated as the general contractor's employees for Section 89 purposes, then the subcontractor's employees will have to be notified of the general contractor's plans. If the subcontractor's employees are not to be treated as the general contractor's employees, then including them may cause the plan to fail Sec. 89 because it is not for the exclusive benefit of employees. The general contractor may be caught in an impossible situation.

If a general contractor is too broadly inclusive, he may fail that part of the test. If he isn't inclusive enough, he will fail a different part of Section 89. If a construction contractor doesn't provide notice of his plans to his subcontractors, he may fail the qualification requirements if the IRS later determines he should have done so.

The issue is not academic. It is an issue the construction industry is struggling to resolve, because the penalties for noncompliance in this area are so severe.

Multiemployer plans. Half of all multiemployer plans are in the construction industry. In meetings with other multiemployer representatives and industries using employees in collective bargaining units, AGC identified some common problems for the Congress' considerations. To understand the problems, it is necessary to examine the nature of multiemployer benefit plans.

Multiemployer benefit plans are common in labor-intensive industries where employees shift from employer to employer within a geographic region. Two or more employers will contribute to a pooled fund on behalf of that part of their workforce covered by a particular contract. The contract is agreed to through a collective bargaining process between representatives of the employers and labor representatives. These multiemployer benefit plans provide various combinations of health, welfare and retirement benefits.

Multiemployer funds are subject to the Taft-Hartley Act and Labor Department regulations. The plans are overseen by joint trustees of labor and management, who set overall policy. Day-to-day decisions are made by a plan administrator.

In the collective bargaining process, employer and employee representatives bargain over the dollar-and-cents contribution based per hours worked. Individual contributing employers are made aware of and contribute that level into the pooled fund. The allocation of the total contributions into various options is the responsibility of the joint labor and management plan trustees.

Individual contributing employers exercise no control over plan benefit design, level of contributions, or health or other benefits and different options within plans. Such decisions are the exclusive responsibility of either the plan trustees or, in some cases, the designated collective bargaining agents. In some cases, plan trustees are even permitted to shift dollars between funds as they deem necessary or reserve a small percentage of the fringe benefit contributions for unforeseen problems in the various funds. Individual contributing employers do not process employee claims for health benefits. Those are processed by the plan offices.

In industries where multiemployer plans are common, the work is labor-intensive and the need for workers shifts from day to day within a geographic area. The overall workforce remains numerically stable. Workers leave and return to one employer several times in the course of the year, as the need for workers at particular projects shifts.

It has been suggested that collectively-bargained plans be tested separately. As can be seen from the preceding description, there are several problems with that approach.

Individual contributing employers have no control over plan design, options or benefits. Individual contributing employers do not know what benefits are paid out to employees. It is typical in multiemployer plan situations that the workforce fluctuates substantially from day to day from employer to employer. The individual contributing employer may contribute the same rate for each worker, but the contribution total for each worker will vary according to the number of hours worked. The worker may leave and return to the same employer several times in the course of the year and that will affect the total contributions, even though the worker has maintained his or her health coverage throughout.

At the same time, the individual contributing employer is paying for health care coverage for large numbers of nonhighly compensated workers.

Leased employees. AGC and other organizations have identified several severe problems with the leased employee rules in the pension area. The Treasury Department has acknowledged that the proposed regulations are too broadly written. Section 89 reform should not import those problems from the pension area that are in the process of being redressed.

Employee leasing is an employment arrangement under which a "leasing organization" leases individual workers that it employs to a "service recipient" for whom the "leased employee" performs services. The leased employee is an employee of the leasing organization. The leasing organization pays the employer's wages, withholds tax and performs the other normal administrative duties of an employer. The service recipient is a business or employer that pays a fee to the leasing organization that covers the employee's wages and the fees of the leasing organization.

In 1982, Congress passed IRC Section 414(n) to prevent the employee leasing rules from being abused. However, the IRS has issued proposed regulations that would

define employee leasing far more broadly than Congress intended. Under the proposed rules, services would be "historically performed" if it is "not unusual" for employees to perform the services in the United 7 States. The "substantially full-time" rule is satisfied if the person has performed 75% of the hours similarly positioned employers perform in one 12-month period.

These and the other proposed rules are written so broadly, they are being treated as covering independent contractors and subcontractors as well as leasing organizations. The proposed regulations would require the subcontractor's employees to be treated as employees of the general contractor for benefit plan purposes. If followed to their logical end, project owners would be required to pay benefits for the employees of the general contractors as well as the subcontractors.

Subcontractors and general contractors are independent businesses. They incur the expenses, and take the risk of profit and loss. They should be treated as such.

There is also a hidden trap in the plan qualification rules as they relate to the leased employee rules. On a construction site, one general contractor works with multiple subcontractor companies. For example, on a commercial building site, the general contractor can have up to 75 subcontracting companies on that one site during the life of the contract.

If the subcontractor's employees are to be treated as the general contractor's employees for Section 89 purposes, then the subcontractor's employees will have to be notified of the general contractor's health plans. If the subcontractor's employees are not to be treated as the general contractor's employees, then including them may cause the plan to fail Sec. 89 because the plans are not for the exclusive benefit of employees. The general contractor may be caught in an impossible situation.

If general contractors are too broadly inclusive, they may fail that part of the qualification test. If they aren't inclusive enough, they will fail a different part of Section 89. If the construction contractor doesn't provide notice of the plans to the subcontractors, he may fail the qualification requirements if the IRS later determines it should have been done. The subcontractors are not required to supply any information to the general contractor or the employees on the job-sites. The subcontractors, because they are treated as the leasing organization, are not compelled to provide information for compliance testing to the general contractor. The general contractor may supply Section 89 information to the subcontractors, but there is no mechanism for ensuring that the actual employer, that is the subcontractors, supply the necessary information to the on-site employees.

Davis-Bacon Act considerations. The Davis-Bacon Act, passed by Congress in 1931, requires that hourly construction laborers and mechanics receive the "prevailing" wages and fringe benefits in a locality on federal and federally-assisted construction projects. The Labor Department conducts surveys and sets the dollar amounts to be paid to laborers and mechanics. The Act applies to both union and non-union workers.

The Labor Department studies local conditions and other statutes to determine what wages and fringe benefits prevail in states, cities or counties. They then issue a general wage determination decision that specifies in dollars and cents the minimum amounts to be paid by contractors and subcontractors to laborers and mechanics. Part of the wage decision is labeled "fringe benefits" and that amount may be used to provide health and retirement benefits. The Davis-Bacon Act requirements may be satisfied if the employee receives the entire amount—both wages and fringe benefits—immediately in cash. If the employer provides health or retirement benefits instead of cash, stringent Labor Department requirements must be met.

Suppose the employer satisfies the Davis-Bacon Act requirements by paying cash. The employees receive their benefits, but not in a format that would satisfy Section 89 as currently written. The employer would have to provide two sets of benefits to satisfy the two statutes. Under Davis-Bacon, there must be the option to pay cash to satisfy the employer's obligations due to the requirements of the Act.

Suppose the employer applies the Davis-Bacon fringe benefit amounts to pay for health insurance. The employer would provide core health coverage to a large number of hourly construction workers. Construction workers leave and come back several times a year to the same employer. It would be difficult to determine whether the Section 89 requirements are satisfied, even though the employer is providing federally mandated benefits. The amounts specified by the Labor Department general wage determination decisions do not necessarily match the dollar amounts paid for other workers. Davis-Bacon amounts may not be used to fund benefits not related to Davis-Bacon work.

Suggested alternatives. AGC believes that the goals of Section 89 can be achieved without forcing employers to divert resources from productive investments to unproductive consultant fees. AGC would like to offer some specific suggestions.

The emphasis should be shifted from actual plan participation to eligibility-based testing. If 70% of the employer's nonhighly compensated employees are eligible for core health coverage as defined by COBRA, the employer passes the eligibility test.

The emphasis should be placed on cost, with adjustments for demographics and geographic location, rather than valuation of benefits. The requirement to test different plan options should be dropped as any different options are reflected in the cost of the plan.

AGC believes the treatment of collectively bargained and multiemployer plans should be clarified to reflect that plan trustees design and operate the plan, not the individual contributing employer. AGC believes the responsibility for compliance and testing, and sanctions for noncompliance with Section 89 should be placed upon the person or persons responsible for the plan. The applicable comparison should be the contribution rate, not the contribution. An individual contributing employer whose workforce consisted of 90% or more employees who are actually covered by collectively-bargained health plans should be deemed to satisfy Section 89 for its entire workforce. This rule would not apply for multiemployer plans covering professionals.

First, the responsibility and sanctions should be placed upon the person or persons responsible for the plan. The appropriate approach is outlined in COBRA. For single employer plans, the employer is responsible. For multiemployer plans, the plan is responsible. Because the plan trustees are responsible for plan design, it should be their obligation to design the plans in a manner that satisfies the Section 89 requirements.

Second, the applicable comparison should be the contribution of the individual employer, not the contribution. The total contributions are affected by the number of hours worked. The employer has no control over how contributions are spent. He or she bargains for the hourly contribution. As long as the rates are not discriminatory, the employer has satisfied its responsibilities.

Third, an individual contributing employer whose workforce consisted of 90% or more employees who participate in one or more collectively bargained plans and who receive health benefits that are the subject of good-faith bargaining could be deemed to satisfy Section 89 for its entire workforce. This follows the general approach of H.R. 1864 which requires that coverage be available to 90% of the nonhighly compensated workers. If that many workers are actually covered, the employer has met its obligations. The plan administrators, as the parties responsible for plan design, would test the plans for eligibility and benefits.

Clarification of the leased employee rules is essential before the rules from the pension area are brought into the health area. Given that the Treasury Department has acknowledged the many serious flaws in the proposed regulations, AGC suggests that leased employees be held in abeyance for Section 89 purposes until those problems are resolved.

The Davis-Bacon Act is analogous to the collective-bargaining process. A federal statute takes the place of the negotiated agreements. Indeed, Davis-Bacon applies to both union and non-union employers. The Labor Department determines the wage and fringe benefit rates for all federal and federally-assisted construction. A federal statute should be given at least the same status as a negotiated contract. Davis-Bacon amounts and workers should be given the same status as collectively-bargained agreements and workers.

The plan qualification rules are already very close to the rules already existing in ERISA and COBRA. The Section 89 requirements are redundant to the extent they are the same as ERISA. The additional requirements do not provide any additional protections for the workers and create unnecessary technical compliance problems for employers.

Sanctions. The sanctions for failure to satisfy the qualification requirements need additional revisions. There are many uncertainties and unresolved issues in Section 89, whether as it exists now or with the changes contemplated by H.R. 1864. Employers making good-faith efforts to comply could be hit with unwarranted and severe tax penalties. This is particularly true in light of the lack of guidance from the IRS on crucial issues.

First, no penalties should be applied this year. All penalties should be delayed until plan years beginning in 1990. With the great uncertainties surrounding Section 89 at this point, it is unfair to penalize employers.

Second, penalties should be applied to the person or persons responsible for the failure to comply. For single employer plans, the employer should be responsible. For multiemployer plans, the plan should be responsible.

Third, the sanctions should be simplified. Taxing the employees or employers on benefits paid is onerous and capricious in its impact. Two employers may have the

exact same fault in their plans. If one employer has an employee who had a heart attack, that employer is penalized much more severely. If a plan fails the qualification requirements, the penalties should be the same as failing the eligibility and benefits testing. There is no rationale for having a separate penalty.

The Treasury Department is beginning to recognize the difficulties employers are facing in implementing Section 89. The recent announcement that testing and notification requirements are postponed until October 1 is very helpful. However, it does pose a difficult problem. If no legislative action is taken, employers will have only a three-month period for compliance. There would be very little time to correct a plan not in compliance. The Treasury Department should announce now that compliance is postponed until plan years beginning after December 31, 1989.

The employment relationship in the construction industry is unique for several reasons. Unlike any other industry, construction companies are faced with constantly shifting jobsites and constantly shifting workforces. Given the phased nature of the construction process, the work force changes as the job progresses. For example, on a commercial building, the electricians may come in, work on several floors, move to another job site to do work there, then come back and work on additional floors and so on until the building is finished.

Once the building is finished, construction workers do not have the choice of staying at the site. They must move on to another jobsite and normally another employer if they want to continue working. That is why the construction industry has a turnover rate of 300%. This creates tremendous uncertainty as to whether a plan will remain in compliance.

The tax-favored treatment of employer-provided employee benefits furthers an important social goal of expanding health care coverage. Section 89 as rewritten by the 1986 tax act had the opposite effect. The problems outlined above support the position AGC has taken on repeal of Section 89. Implementation of the statute should be postponed until the many serious problems already identified can be resolved.

Meanwhile we are obliged to again emphasize that Section 89 as rewritten by the 1986 tax act is having and will continue to have a disastrous impact on the construction industry alone. Faced with the complexities, contradictions and numerous flaws in Section 89, construction contractors, the overwhelming majority of which are small, family-owned businesses will be obliged to discontinue benefits, because the provision of those benefits is so seriously jeopardized by a Section 89 so flawed that its repeal is widely supported.

AGC appreciates this opportunity to review some special problems and looks forward to working with the Committee and with Congress to resolve these problems.

THE BEST RENTAL STORE, INC.

Hon. Senator PETE DOMENICI,
Dirksen Senate Office Building,
Washington, DC.

Dear Senator Domenici: This letter is in reference to Section 89. The Best Rental Store has found it in their better judgment and interest *not* to support section 89.

As a small business, Section 89 is very unbeneficial. With fewer than ten (10) employees, this plan would only prove itself to be extremely costly. Being difficult as it is to supply full time employees with good insurance, particularly health insurance packages, making it mandatory to extend these benefits to lower income employees would not only cause problems for both employer and employee, but be entirely too expensive as well as complicated.

Once again, The Best Rental Store does *not* support Section 89!

Sincerely,

TAMI G. MCBEE, *President/Owner,*
The Best Rental Store, Inc.

STATEMENT OF THE BLUE CROSS AND BLUE SHIELD ASSOCIATION

The Blue Cross and Blue Shield Association appreciates the opportunity to submit written comments concerning modification of Section 89 of the Internal Revenue Code of 1986 to simplify the nondiscrimination rules applicable to certain employee welfare benefit plans. As the coordinating organization for all the Blue Cross and Blue Shield Plans, we are vitally interested in any federal legislation that affects the administration of employee benefit plans and the scope of benefits that such plans may offer. Our 75 member non profit plans provide health insurance protec-

tion to over 77 million Americans. The majority of this protection is in the form of employment-based group health benefits.

We applaud the Committee's commitment to review the requirements of Section 89 and to consider revisions to the legislation. We are concerned about the increasing demands placed on employers who offer health benefit plans to employees and, in particular, whether additional requirements could result in some employers no longer providing such health benefits.

The Blue Cross and Blue Shield Association has supported fully Congress' initial intent in drafting Section 89—that health benefits provided to highly compensated employees which substantially exceed benefits provided to non-highly compensated employees should not receive favored tax treatment.

However, the Section 89 legislation and the proposed regulations implementing the legislation have become so complex that they have become an overwhelming burden on employers. We are concerned that this burden may result in reductions or even elimination of employer-provided health benefits especially by small and medium sized employers. We also are concerned about the significant cost to employers of compliance. For these reasons, the Association strongly supports efforts to simplify Section 89.

We commend Senator Pryor for his early lead in the simplification effort. Senator Pryor's bill, S. 654, represents an important step towards reducing the administrative burdens of Section 89. It would create a "safe harbor" for employers that provide a health benefit plan available to 90 percent of its employees with a limit on employee contributions of $6.70 per week for a single policy and $13.40 per week for a family policy. S. 654 facilitates the performance of the one day snapshot test by eliminating the need for employers to adjust for the elections of highly compensated employees during the testing year on a different basis than for their non-highly compensated employees. In addition, S. 654 removes the requirement that an employer must have at least one highly compensated employee, even if no employee of the entity earns as much as $45,000. This amendment may prove to be beneficial to not-for-profit and government entities and certain small business. S. 654 would reduce the number of part-time employees that must be included in testing by liberalizing the definition of excludable part-time employees to encompass those who work less than 25, instead of the present 17½, hours per week and would phase-in the testing of part-time employees gradually: starting with those working less than 30 hours in 1989, dropping to 27½ in 1990 and eventually reaching the 25 hour threshold in 1991. Furthermore, S. 654 modifies the current penalties by setting coverage-based penalties for both test and qualification requirement failure.

While we support many of the provisions in S. 654, we are concerned that it would preserve the current Section 89 data collection requirements for those employers unable to satisfy the safe harbor provisions.

H.R. 1864, introduced by House Ways and Means Committee Chairman Dan Rostenkowski, takes a somewhat different approach to revise the nondiscrimination legislation, simplifying or eliminating many of the aspects of Section 89 that make its present version costly and administratively complex. By focusing on the *availability* of coverage rather than how employees sort themselves among options, the bill significantly reduces the amount of data required to comply with Section 89.

Under H.R. 1864, the current nondiscrimination tests would be replaced by a simplified eligibility test: at least 90 percent of all nonexcludable, non-highly compensated employees must be eligible to participate in one or more "qualified core health plans;" the plans could not contain a provision related to eligibility that discriminates in favor of highly compensated employees; and required employee contributions to such plans could not exceed $10 per week for single coverage or $25 per week for family coverage. These dollar amounts would be adjusted for post-1988 cost-of-living increases as measured by the Social Security Administration average wage index.

In addition, H.R. 1864 would reduce the number of part-time employees that must be included in testing from those employees working 17½ hours per week to those working 25 hours per week.

H.R. 1864 also would diminish significantly employer data collection burdens, facilitate the performance of the one day snapshot test, lessen the difficulties involved in incorporating leased employees into the employer's work force for testing purposes, eliminate the need for "sworn statements" and establish more equitable penalties when the plan fails the qualification tests.

We welcome Mr. Rostenkowski's efforts to simplify the Section 89 requirements as a significant improvement over the current law and regulations. We have identified however, several areas which we believe should be reviewed further.

THE 90 PERCENT TEST

The bill would replace the complicated tests of current law with a single alternative test based on design of the plans. The requirement would be that at least 90 percent of all nonexcludable, non-highly compensated employees be eligible for coverage. While we are fully supportive of making health benefits as broadly available as possible, we believe that the 90 percent standard may be too high. It may result in some employers who are currently offering broad based benefits actually failing the tests and sustaining the full tax penalty. We would suggest that the threshold be lowered, perhaps to 80 percent. This would mitigate the adverse impact of the so-called "cliff effect."

EMPLOYEE CONTRIBUTION CAP AND INDEX

The Association is concerned about the potential consequences of the dollar limit placed on employee contributions in the definition of a qualified core health plan. This provision limits an employer's ability to have all employees share in premium costs without imposing a severe tax penalty on highly compensated employees. Consequently, to comply with these provisions, employers have no choice but to lower the cost of their plans by "designing-down" their existing benefit structure, for example, by introducing higher deductibles or copayments. One way to resolve this problem is to increase the employee contribution limits.

The provision indexing future increases in the employee contribution to wages also encourages employers to design-down their plans since medical costs are increasing at a faster rate than wages. Over time, if the cap is indexed to wages, increases in the cost of medical care would significantly reduce the employee's share of the health plan costs. In order to keep in balance the allocation of health care costs between employers and employees, the limits should be indexed to increases in the per-capita U.S. health care expenditures. This indexing mechanism would relieve some of the pressure on employers to design-down their benefits.

PART-TIME EMPLOYEES

H.R. 1864 would increase the threshold for inclusion of part-time employees in the nondiscrimination testing from 17½ hours to 25 hours. We support liberalizing the definition of part-time workers but urge consideration of a phased-in program starting with a definition of part-time workers based on 30 hours (the industry norm today) and moving to 25 hours over the next few years.

ONCE-A-YEAR TESTING

Although we strongly support the elimination of the continuous testing requirement for non-highly compensated employees, we remain concerned about the continuous testing requirement for highly compensated employees. We would suggest that the bill be revised to provide for a once-a-year test for highly compensated employees.

SALARY REDUCTIONS

The bill treats salary reduction contributions as employer contributions for determining a highly compensated employee's employer-provided benefit and as employee contributions for purposes of the benefits test and the 90% eligibility test. Such treatment would limit the amount that all employees (non-highly compensated as well as highly compensated) could contribute to a Section 125 plan for core benefits ($520 for employee only coverage and $1300 for family coverage). This treatment would also result in a disparity in coverage provided to highly compensated and non-highly compensated employees. The consequence would be increased potential for taxable income to highly compensated employees obtaining core benefits through salary reduction programs. The bill thus would discourage the use of tax-favored salary reduction programs both for non-highly compensated as well as highly compensated employees. We would be pleased to work with the Committee to resolve this difficult issue.

IMPLICATIONS FOR SMALL BUSINESS

The Association has a special concern regarding the effect of Section 89 requirements on small businesses. We would urge consideration of provisions that would ease the burden on small business sufficiently so that they are encouraged to continue to provide employee benefit programs to their employees and expand these programs to employees that they presently do not cover.

The Finance Committee has an opportunity to develop a bill which addresses some of the concerns expressed about S. 654 and H.R. 1864. We would offer an alternative approach for your consideration as you are developing simplification legislation. This alternative would allow employers to satisfy the nondiscrimination requirements by satisfying two simple tests: the nondiscriminatory provision test of current law, and a new quantitative eligibility test. The eligibility test would be satisfied if at least 90 percent of the employer's non-highly compensated employees (NHCEs) are eligible for a benefit equal to 75 percent of the largest benefit available to any highly compensated employee (HCE).

In applying the 90 percent/75 percent test, the employer first must determine whether 90 percent of NHCEs are eligible for benefits and establish the value (premium or cost) of the benefits. If the value of the benefit available to 90 percent of the NHCEs is equal to at least 75 percent of the largest benefit available to any HCE, the plan passes. If the plan fails the test, the employer then must determine the value of benefits actually received by both HCEs and NHCEs. Each HCE will be taxed on the difference between the benefit received by the HCE and the average value of benefits received by all NHCEs.

We feel that our proposal offers several advantages over H.R. 1864. The 90 percent/75 percent test, like the 90 percent/133 percent test of H.R. 1864, requires employers to make nondiscriminatory health insurance coverage available to a broad range of employees. Instead of placing caps on employee contributions, however, the 90 percent/75 percent test measures the relative benefits provided to HCEs and NHCEs. HCEs are subject to penalties only if they are eligible to receive benefits that are disproportionate to the benefits available to the other employees. The 90 percent/75 percent test thereby eliminates the incentive created by employee contribution caps to design coverage down to an affordable level.

In addition, the cliff effect penalty for failure of the eligibility test under H.R. 1864 may effectively discourage employers from continuing or expanding coverage for less than 90 percent of their non-highly compensated work force. By basing the penalty calculation for highly compensated employees on the average value of benefits received by NHCEs, the 90 percent/75 percent test gives employers credit for the value of any health insurance benefits actually provided to NHCEs.

Finally, the 90 percent/75 percent test requires approximately the same amount of data collection as H.R. 1864, and is much more simple to perform.

In summary, we support the goal of nondiscrimination in the provision of employee health benefits. However, we are concerned that Section 89, in its current form, may result in the reduction or elimination of employer provided health benefits by many small and medium sized businesses. S. 654 and H.R. 1864 would substantially simplify the burdensome aspects of Section 89 and we commend these efforts. However, we believe that additional improvements are needed and urge the Committee to develop legislation which incorporates the suggested changes in H.R. 1864 or the alternative proposal set forth in our testimony.

Once again, we appreciate the opportunity to submit written testimony and look forward to working with the Committee as these difficult issues are addressed.

STATEMENT OF CASTLE & COOKE, INC.

I.—INTRODUCTION AND SUMMARY

This statement is submitted by Patton, Boggs & Blow on behalf of Castle & Cooke, Inc. for inclusion in the record of the hearings held by the Committee on Finance on the nondiscrimination rules applicable to employer-provided fringe benefits contained in Section 89 of the Internal Revenue Code. Castle & Cooke, a Hawaii corporation with its principal executive offices in Los Angeles, California, is a major participant in the world-wide food products industry and is a major real estate owner and developer. Castle & Cooke believes that the inordinately complex provisions of current Section 89 should be restructured and greatly simplified.

This statement is directed to the so-called "separate line of business" exception contained in current Section 89(g)(5). Under this exception, if an employer has separate lines of business or separate operating units, the nondiscrimination rules of Section 89 (and the qualified retirement plan minimum coverage requirements of Section 410(b)) are applied separately to each separate line of business or operating unit. The separate lines of business exception thus recognizes and encourages competitiveness among providers of different products and services without abandoning fundamental nondiscrimination policy objectives.

Castle & Cooke believes that a single common definition of "separate line of business" is essential and, as explained below, that the present test set forth in Section 414(r) requires additional precision. Present law should be amended to assure such identity of definition and to clarify the manner in which the "separate line of business" test (now set forth in Section 414(r) and applicable by cross references to Section 410(b) and, with certain modifications, to Section 89) is to be applied to diversified companies such as Castle & Cooke.

Castle & Cooke fully expects that, under Section 414(r), its real estate development activities would be considered a line of business separate from its participation in the food industry. Moreover, Castle & Cooke believes that its world-wide participation in the food industry should *not* be treated as one single line of business under the existing provisions of Section 414(r). Such treatment would not be in accordance with the purpose of the separate line of business exception, because the food industry consists of many competitive environments that are fundamentally different from each other and Section 414(r) should be clarified in this respect.

As explained more fully below, the activities of Castle & Cooke (and its directly and indirectly owned subsidiaries) in the world-wide food products business are organized into separate business groups. The different competitive environments within which each business group competes impose a market-oriented discipline on the "benefits" component of their respective cost structures (i.e., benefit levels must be sufficient to attract and retain qualified employees, but cannot be so costly that they impair the ability to compete effectively). Section 414(r) was enacted to address precisely this kind of situation, but legislative clarification is vitally needed.

II.—CASTLE & COOKE FOOD PRODUCTS ACTIVITIES

A. Overview.

Originally, the activities of Castle & Cooke in the food industry were limited to packaged foods (mostly canned pineapple) and sugar. Today, largely as a result of acquisitions made over the past three decades, Castle & Cooke's world-wide food products activities employ approximately 42,000 people (about 10,000 of whom work in the United States) involving the following:

- bananas and fresh pineapples
- packaged foods
- table grapes
- citrus fruits
- fresh vegetables
- dried fruits and nuts
- sugar
- retail food operations

With the exception of the packaged foods business group (operated as a separately managed unincorporated division of Castle & Cooke), each of the business groups is operated through one or more separate subsidiaries of Castle & Cooke.

Most of the food business groups use the "pole" name on one or more of their products and are subject to oversight from the parent company, but these similarities should not obscure their fundamental differences and operational independence. Each of the business groups has a separate organizational structure and is headed by a separate management team that is accountable for that business group and with separate production and/or marketing personnel. Each business group is headquartered in a different geographic location and operates as its own profit center with exclusive responsibility for operations, pricing, cost control and all other aspects of its business activities. In short, each business group could stand alone as an independent company. Moreover, with the exception of certain 1987 acquisitions, the business units operated in this autonomous configuration prior to the enactment of Sections 414(r) and 89.

B. Illustration of the Problem.

The situation confronted by Castle & Cooke and other similarly situated employers may readily be illustrated through a brief summary description of three of the several business groups into which Castle & Cooke has organized its world-wide food business: (1) bananas and fresh pineapples; (2) packaged foods and (3) table grapes.

1. Bananas and Fresh Pineapples. Through this business group, headquartered in Boca Raton, Florida, Castle & Cooke exports fresh bananas grown in foreign countries (Costa Rica, Honduras, Columbia, Ecuador and the Philippines) by indirect subsidiaries of Castle & Cooke and by unrelated third parties. The domestic employees of this business group manage the operations of the foreign subsidiaries and arrange for the purchase, distribution and sale of bananas. Such sales are made in North America, Western Europe, the Far East and the Middle East. (Certain domestic em-

ployees of this business group also are responsible for the distribution and sale of fresh pineapple grown in Hawaii, Honduras, and the Philippines by a division of Castle & Cooke.) The principal competitors for this portion of this business group are United Brands, Del Monte and other importers.

2. Packaged Foods. Dole Packaged Foods, a division of Castle & Cooke headquartered in San Francisco, California, produces and markets processed foods, such as packaged pineapple products (sliced, chunk, and crushed pineapple in cans), juices, frozen desserts and other packaged food products. These products are sold in various markets, principally in North America, Europe and Japan. The various products of Dole Packaged Foods compete against products of companies in their own markets, including Del Monte, Maui pineapple, and various importers of the Thai pineapple for pineapple products, Del Monte and Minute Maid for juices, and General Foods, Pillsbury, Kraft, United Brands and other manufacturers and dairies for frozen desserts.

3. Table Grapes. The employees of a separate business group, headquartered in Bakersfield, California and acquired by Castle & Cooke in 1987, grow California table grapes and provide packing and marketing services. The principal competitors of Castle & Cooke in the area of table grapes are independent family-owned businesses.

In order to compete effectively on a world-wide basis, each of these business groups and the other Castle & Cooke business groups must have a cost structure that reflects the realities of its individual environment. This means that, with respect to employee benefits, each business group must provide benefits that are sufficient to attract and retain qualified employees, but which do not increase costs to the point where they impair the ability of that business group to compete effectively.

III.—THE NEED FOR LEGISLATIVE CLARIFICATION

Neither section 414(r) nor the legislative history of that provision provides adequate guidance with respect to what constitutes a "separate line of business" and whether any such separate line of business was established for "bona fide business reasons." Statutory clarification is required on both of these points to insure that companies such as Castle & Cooke which operate in multiple environments have adequate assurance that their separate business operations will be treated as such under section 414(r).

As the preceding food business group illustrations indicate, the Castle & Cooke organization structure exists for bona fide business reasons and is not designed to thwart any nondiscrimination employee benefit rules. Consequently, the Castle & Cooke food organizations ought to be treated as "separate lines of business" under Section 414(r).

The cost structure point in the preceding illustrations is critical. To take but one example, if Castle & Cooke were required to equalize the benefit levels of the domestic employees of the bananas and fresh pineapples business group with those of the table grapes business group, it would face an impossible choice. It could raise benefit levels in the table grapes business group to those prevailing in the bananas and fresh pineapples business group (thus pricing itself out of the competition in the table grapes business group). Alternatively, it could lower the benefit levels of the domestic employees in the bananas and fresh pineapples business group to those prevailing in the table grapes business group (thus jeopardizing its ability to attract and retain qualified domestic employees in the bananas and fresh pineapples business group).

Castle & Cooke, and other similarly situated employers, should not face such a choice. If these two business groups (bananas/fresh pineapples and table grapes) were owned and operated by different corporations, they could both provide benefit levels consistent with the respective cost structures to which they must conform. There is no reason to require a contrary result just because both business groups are owned by a single corporation such as Castle & Cooke and Section 414(r) can and should be applied to prevent such a result. Treatment of the business groups of Castle & Cooke engaged in the world-wide food industry as "separate lines of business" under Section 414(r) would accord both with Castle & Cooke's actual operations and with the differing cost structures and other business realities each such business group must confront while still accomplishing the important policy objectives that prompted Congress to enact that provision as part of the Tax Reform Act of 1986.

IV.—CONCLUSION

It obviously is essential that legislation be enacted to resolve the myriad of problems presented by current Section 89. For the reasons set forth in this statement, Castle & Cooke believes present law should be amended to clarify explicitly that the "separate line of business" test (as applicable for all relevant purposes) was intended to avoid the very kind of problems now confronted by Castle & Cooke as it seeks to provide benefit levels consistent with the cost structure and employee retention constraints faced by each of its business groups. Castle & Cooke stands ready to assist the Committee on Ways and Means and its staff in developing appropriate and workable "safe harbor" or other provisions to deal with such issues in a responsible fashion and to provide such additional information as may be appropriate with respect to its own business groups in the world-wide food industry.

STATEMENT OF THE CITY OF NEW YORK (SUBMITTED BY ROBERT W. LINN, DIRECTOR OF PERSONNEL AND LABOR RELATIONS)

Mr. Chairman, I am grateful for this opportunity to present the views of the City of New York to your Committee, and I am pleased that the Committee is earnestly pursuing the goal of simplifying Section 89.

We in New York City have some unique problems with Section 89. I would like to tell you about the benefits structure for City employees, so you can understand why we have so much difficulty complying with current law. First, we employ over 310,000 individuals in a variety of occupations—including nurses, teachers, policemen, prison guards, laborers, and attorneys. Ninety-six percent of this workforce is represented by labor unions, which has been the case for over twenty years, and there are over 70 different labor organizations in the City. In addition, there are 135,000 retirees who receive pensions and health benefits from the City. Thus, the City is providing health benefits to almost half a million individuals, plus their dependents.

We provide a tremendous variety of health benefits to our employees because the City offers all employees a choice of up to thirteen basic health plans and then the 70 unions and the Management Benefits Fund (for all titles not in collective bargaining) adds its own package of supplemental benefits, which we fund through contributions to the welfare funds. Although the City makes a uniform health insurance contribution and has offered a uniform welfare fund contribution for each employee, the resulting contributions and benefits are anything but uniform.

Health insurance and related fringe benefits are a mandatory subject of collective bargaining in the City. All City employees are eligible to choose from the thirteen basic health plans which provide medical and hospital coverage. Seven of these thirteen plans are provided at no cost to the employee, and six require an employee contribution because their plan costs are greater than the fixed employer contribution agreed to in bargaining. Additional coverage is provided through optional benefits riders, which consist of added benefits like prescription drugs and appliances. These optional benefits are fully employee-paid and again, in each plan are available to all employees at the same cost.

Another tier of coverage is provided by the over 70 separate union-administered welfare funds and the Management Benefits Fund. An employee's eligibility for a particular benefit fund is determined by an independent board through collective bargaining certifications. This results in union welfare fund coverage for employees who are in titles certified to a union, but who are individually exempt from all collective bargaining, e.g. an office aide who works in a labor relations, budget or personnel office. The unions negotiate with the City for fixed per capita contributions for current and former members, so as to provide them with supplemental benefits such as vision, or dental benefits. The employer paid welfare contribution has generally been uniform for all groups. However, since the determination of this amount is part of collective bargaining, unions do have the right to "trade-off" wages or other benefits for higher welfare fund contributions or to divert pattern welfare fund increases to augment wages or other benefits. For example, in the 1987-90 round of bargaining, the Sanitation Union chose to forego the $150 welfare fund increase in exchange for $150 in higher wages. While we start out treating all groups alike, the results for each group may be very different.

In recommending to you how to simplify Section 89, let me do so by commenting on H.R. 1864, the bill introduced by Chairman Rostenkowski. That bill is a significant improvement over current law and would greatly simplify our task of trying to comply with Section 89. It is not a perfect solution for the City, but it is a good starting point for helping us with the impossible job we have under current law of

testing for nondiscrimination in health benefits. The provision that would help us the most is the separate testing of collective bargaining units, although this creates other problems for us which I will discuss later.

H.R. 1864 would make it possible for us to certify that the array of health benefits offered to our employees is nondiscriminatory without having to do the complex testing we now have to do under Section 89. We have, however, two major concerns about H.R. 1864, and a number of questions as to how certain provisions of the bill will be interpreted that we would like to share with you.

Our first concern relates to the fact that, under the bill, "professional" unions are not considered "qualified bargaining units" for the purpose of separate testing for Section 89 compliance. This provision has been drafted too broadly—it excludes bargaining units based on their field of work, i.e. law, health, rather than on the basis of their relationship to management. It would classify many of our unions as "professional bargaining units" because they cover health aides, staff attorneys, accountants, and other people in the fields identified in the bill. We view these as "rank and file" employees, even though they may be in "professional" lines of work, and the statutory labor scheme in New York views them similarly. I would suggest that this situation is also true of many other public sector employers, as well. If there is going to be an exclusion of "professional unions" from separate testing, we think the definition of a "professional union" should focus on owners and managers and not on every worker in the profession.

Our second major concern is that the treatment of salary reduction in H.R. 1864 would limit our ability to offer a flexible spending account or salary reduction plan providing health benefits, and we think this type of plan would be beneficial to our employees. Further, this type of plan is subject to collective bargaining and the unions negotiating with the City have demanded this plan for their members.

The difficulty that the City has with the salary reduction provision is that it treats such deductions as employer contributions for purposes of determining a highly compensated employee's employer-provided benefit. As I noted earlier, due to collective bargaining, several of our health plans require an employee contribution for basic coverage and many have an employee contribution for various riders that are open to all employees. Requiring that these premiums be paid with after-tax dollars by those highly compensated employees who will participate in the salary reduction plan would be unfair. While private sector employers have the option of "grossing up" to allow their highly compensated employees to continue to receive these benefits, in the public sector we have no such option. Instead, we would probably be forced either to reduce our health benefits for both highly compensated and non-highly compensated employees or limit or discontinue any salary reduction through a medical spending account. We believe this provision should not be included at all, but particularly when it applies to salary reduction due only to employee-paid premiums.

In addition to these concerns, we have five issues in H.R. 1864 we think need to be clarified:

(1) The terms "core" and "primarily core" benefits need to be defined more precisely. It is not clear to us which of the medical benefits provided through our union welfare benefit funds would be considered "primarily core" and thus part of the basic health benefit.

(2) The bill needs to clarify whether or not COBRA rates can continue to be used in determining the "value" of benefits—the bill leaves the issue of valuation to the Secretary, while the Committee's description of the bill states that current law, particularly as enacted in TAMRA, will continue to apply. Since COBRA rates are already established and accepted, it is our preference to use COBRA rates.

(3) There needs to be a clear definition of "former employees." Although the bill delays the application of the rules to former employees for one year, it does not clarify whom we should consider former employees or establish any guidelines on how to apply the law to this group.

(4) The bill needs to clarify how collectively bargained groups are to be treated for testing purposes. We have many employees in the City who are covered under union health plans but are not voting or dues-paying members of the collective bargaining unit due to statutory restrictions on job classifications and other reasons. Are these employees included in testing the union plan or included in some other group?

(5) The bill provides for a cost of living adjustment to the maximum dollar amount of employee contribution to a "qualified core health plan" which is keyed to the SSA wage index. The City believes it would be more appropriate to provide a cost of living adjustment based on the medical CPI.

In closing, I must say that there are unique circumstances in the public sector that demand special consideration, especially in those situations in which so much of the workforce is covered under collective bargaining agreements. We are mindful that you are opposed to outright exemptions for these situations; however, there are many intricacies in collectively bargained public sector benefits. In the City of New York, we do not give any one class of employees any better benefits than any other, unless a union chooses to alter the items within the bargaining package. We also give our managerial employees the same benefit package that is offered as part of the pattern settlement for all employees. Finally, in the public sector, we are open to intense public scrutiny so that any discrimination in the level of benefits would quickly be identified by one of the many constituent groups in the City.

Mr. Chairman, I applaud your efforts and the efforts of this Committee to reduce the tremendous measurement and testing burden that would otherwise fall on the City under Section 89, and I urge you to examine the issues I have raised with you today.

COALITION ON STATE AND LOCAL EMPLOYEE PENSION AND BENEFITS ISSUES

Hon. LLOYD BENTSEN,
U.S. Senate,
Washington, DC.

Dear Mr. Chairman: The undersigned public interest groups, which represent state and local governments, support the application of nondiscrimination rules to health and welfare plans. We do not, however, support Section 89 in its present form. The existing rules do not take into account many of the special problems of state and local governments including budget constraints, statutorily mandated benefits, and legislated salaries.

On the other hand, we applaud the measures to simplify Section 89 which are currently being considered—specifically H.R.1864 and S.654. These measures address some of the concerns of state and local governments, such as the one-officer rule and increasing the threshold for excludable part-time employees. In spite of the pending measures, state and local governments continue to have concerns about Section 89. Some of these concerns are:

PART-TIME EMPLOYEES: Although raising the threshold for excludable part-time employees from 17½ to 25 hours is an improvement, many of the part-time employees for state and local governments work more than 25 but less than 30 hours per week. Providing benefits to such employees would be extremely costly and, in some cases, would require legislative authorization. We support raising the threshold for excludable part-time employees to 30 hours per week.

CAFETERIA PLANS: State and local government employers sponsor many cafeteria plans that allow employees to buy benefits using salary reduction, which is uniformly available to both highly and nonhighly compensated employees. H.R. 1864 treats salary reduction as employee contributions when made by nonhighly compensated employees and as employer contributions when made by highly compensated employees for the benefits test. We believe that salary reduction which meets any applicable dollar limitation and is matched by adequate employer contributions should be included in determining the value of benefits available to nonhighly compensated employees. In addition, cashable credits, that is employer contributions which can be taken in cash, should be treated as what they are—employer-funded benefits.

AFFORDABILITY AND INDEXING: Limiting affordable benefits to those costing $10 per week for individual coverage and $25 per week for family coverage is too restrictive. At least 27 states and many local government plans already charge employees more than those amounts for coverage, and more will need to do so in the near future. Despite the fact that these plans do not meet the proposed affordability requirements, they typically provide very broad coverage of nonhighly compensated employees. In addition, with the increasing cost of medical care, the limits should be indexed in a manner that reflect medical costs.

DATA COLLECTION: The data collection and recordkeeping under the simplified rules would still be an administrative and fiscal burden for state and local governments. For example, under H.R. 1864, employers must be able to identify and track highly compensated employee benefits on a daily basis. Many state and local governments do not have the computer capability to compile this comprehensive information. If the availability test under H.R. 1864 were modified to apply the 133% rule to compare the average benefits available to nonhighly compensated employees

with the average benefits received by highly compensated employees on a snapshot, one-day-a-year basis, the data gathering burdens would be substantially reduced.

DEFINITION OF EMPLOYEE: State and local governments need clarification of the definition of employees. For example, are prisoners in state penitentiaries employees because they are paid minimal amounts to work for the institution? Are firefighters who are paid stipends or allowances employees?

DEFINITION OF EMPLOYER: State and local governments also need clarification of the definition of employer. There are detailed rules for the private sector describing the circumstances in which disaggregation of employers is possible. There are no such rules for the public sector. For example, should we treat the three branches of state government: the executive, the legislative, and the judicial as separate employers for testing purposes?

SEPARATE TESTING RULE: State and local governments are often legally required to provide benefits to certain part-time employees. Under current Section 89 law, the separate testing rule allows employers to disregard employees in the part-time, seasonal, short-service, and underage categories even though some employees in those categories are eligible for some type of benefit. This rule should be maintained in any legislation which will replace current Section 89.

COLLECTIVELY BARGAINED PLANS: Under H.R. 1864, plans maintained pursuant to collective bargained agreements are tested separately when testing benefits provided to employees covered by collectively bargained plans. We believe that rather than mandating separate testing, the employer should be given the option of testing union employees separately or as a part of its total workforce.

ALTERNATIVE COVERAGE TEST: Even with the above improvements, an availability test will not work for all employers. There will always be some employers that provide nondiscriminatory benefits to their nonhighly compensated employees, but who still fail the design-based eligibility test. We believe that such employers should be given the option to test their health plans under a simplified coverage test.

Clearly state and local governments have some unique compliance problems. In addition, state and local governments receive no tax advantages from providing employee benefits. For us, providing employee benefits is the "cost of doing business" which contributes to the recruiting and retaining of a qualified workforce. To limit our benefit options would contribute to an increase in—the cost of government and would not translate into improved benefits for state and local government employees. We urge you to address the above concerns regarding compliance with Section 89 for state and local governments and we would appreciate the opportunity to work with you and your staff to that regard.

Sincerely,

GOVERNMENT FINANCE OFFICERS ASSOCIATION
NATIONAL ASSOCIATION OF COUNTIES
NATIONAL ASSOCIATION OF STATE AUDITORS, COMPTROLLERS AND TREASURERS
NATIONAL CONFERENCE OF STATE LEGISLATURES
NATIONAL PUBLIC EMPLOYER LABOR RELATIONS ASSOCIATION
STATE AND LOCAL GOVERNMENT BENEFITS ASSOCIATION
U.S. CONFERENCE OF MAYORS

Ms. LAURA WILCOX,
Hearing Administrator,
Committee on Finance,
U.S. Senate,
Washington, DC.

Dear Ms. Wilcox: On behalf of the County of Los Angeles, I have enclosed written comments by Richard B. Dixon, Chief Administrative Officer, recommending repeal or amendment of Section 89 of the Internal Revenue Code. I request that you include these comments in the record of the May 9, 1989 hearings conducted by the Senate Finance Committee, and I urge the Committee's consideration and positive action on the County's recommendations at such time as relevant legislation comes before the Committee.

We are aware of and agree with the national policy goal of making available employee benefits to non-highly compensated employees in a non-discriminatory manner. Consistent with this goal, the County makes available a broad, uniform benefits package to its employees, just as do virtually all other state and local governments.

Because of the County's longstanding policy, the members of the Board of Supervisors have concerns about the inclusion of state and local governments under the requirements of Section 89 when the Federal Bureau of Labor Statistics has shown that the vast majority of local governments already provide medical coverage virtually to all of their employees.

The County urges the Committee's consideration of either repeal, exemption of state and local governments, or, minimally, amendments to current statutes to lessen the regulatory burden on agencies which are already meeting the spirit and intent of the law.

Mr. Richard Dixon will be happy to answer any questions you may have relative to his comments on current statutes, or you may wish to call me or Mrs. Frieda Wallison, the County's Washington, D.C. representative, at (202) 879-3939. We look forward to a continuing dialogue on this significant issue.

Sincerely,

RANDALL E. DAVIS,
Jones, Day, Reavis & Pogue.

COMMENTS RELATING TO SECTION 89 OF THE INTERNAL REVENUE CODE

The Chief Administrative Officer of the County of Los Angeles, Richard B. Dixon, on behalf of the County's Board of Supervisors, wishes to present to the Senate Finance Committee his comments on issues of concern to Los Angeles County relating to Section 89 of the Internal Revenue Code.

The County agrees that ensuring that employee benefits are made available to rank and file employees in a non-discriminatory manner is a desirable national policy goal. Consistent with the intent of this policy, the County, similar to virtually all other state and local governments, makes a uniform package of benefits available to its employees.

There are certain requirements of the statute which we believe will result in unanticipated results or are unnecessary and which we believe should be modified to minimize the impact on local governments, whose continually diminishing resources are already fully dedicated to basic taxpayer-supported initiatives.

State and local governments have been shown by the Federal Bureau of Labor Statistics to be by and large equitable providers of medical and life insurance to their employees. In addition, county governments have an obligation to pay the considerable costs of uncompensated health care in some cases for those workers presently uncovered by health insurance.

We will appreciate the Committee's strong consideration of the following recommendations for amendment to current Section 89 requirements:

1. *Repeal Section 89 and replace it with a more straightforward strategy consistent with the goal of the Congress to expand health coverage.* Such revised legislation should clearly permit the continued viability of cafeteria benefit arrangements which have been installed by large and small employers to deliver benefits appropriate to the needs of employees at all levels of compensation, or;

2. *Exempt state and local governments from the requirements of Section 89.* As mentioned above, it has been demonstrated that the vast majority of state and local governments currently offer broad, equitable coverage to their employees, thereby already meeting the spirit and intent of the law. Further, it is not realistic to assume that state and local taxpayers ever have or would tolerate a wide disparity in pay or benefits among government employees.

Finally, approximately 90 percent of the County's large workforce is unionized. The contracts covering these employees have been negotiated in good faith between the County and appropriate union representatives and represent what both parties believe to be the most advantageous insurance benefit arrangements for all union members.

3. *Should neither of the previous more equitable recommendations be implemented, then amend current Section 89 requirements to do the following:*

a. Delay the implementation of Section 89 requirements for one year so as to allow employers time to await final legislative resolution of significant Section 89 issues and, where necessary, to adjust employee benefit coverage to conform to enacted legislation.

b. Specify that salary reduction amounts, which under the current statute would have to be considered toward a highly-compensated individual's health plan contribution for testing purposes, be excluded from the test and controlled separately. This would have the effect of continuing health insurance coverage tests while maintaining the integrity of cafeteria plans, which under the current statute lose their effectiveness as benefit delivery systems for an extremely diversified large workforce.

c. Specify, with regard to excluded employees, that employees who normally work less than 12 months are able to be excluded from testing requirements. This would aid jurisdictions, particularly counties whose resources are limited, in the provision of basic local government services to the public such as park maintenance, election operations, and tax collection.

d. Exclude overtime earnings mandated by law in determining whether an employee is "highly compensated." This recognizes that in some organizations, there may be a heavy concentration of rank-and-file employees included by definition as highly compensated merely because there is exceptional workload at some point in time and the employer must pay overtime per federal statutes and regulations,

Further, there are several bills which would modify current Section 89 provisions, the most significant of which appears to be H.R. 1864 (Rostenkowski). While that bill is designed to simplify current statutes, it would not ease the regulatory burden on employers, including Los Angeles County, with cafeteria plans. In fact, it would have certain additional negative effects.

We have informed the House Ways and Means Committee of our strong objection to the provision relating to treatment of salary reduction which would have the effect of virtually eliminating cafeteria plans. We have proposed the separate testing of health insurance and salary reduction amounts so that insurance coverage could still be regulated while at the same time permitting the continuation of cafeteria plans.

We also have strong concerns about the proposal to exclude certain unions from the definition of "qualified." Local governments have many unionized employees in the fields proposed to be excluded, including health, law, engineering, and accounting, whose representatives bargain in good faith for equitable benefit coverage.

We believe that local governments ought not to be included under current statutory requirements because we have already been shown in the vast majority of cases to be providing equitable health benefits. We have offered the above amendments as less attractive but workable alternatives in an attempt to correct what we believe to be inequities in the statute's requirements.

STATEMENT OF CONGRESSMAN PHILIP M. CRANE

Mr. Chairman, it is with great relief that I submit written testimony before this committee on what many have deemed the biggest "tax" issue for this esteemed group of Members this year. Section 89 of the Internal Revenue Code has taken us all on an emotional roller-coaster ride in our attempts to better understand its provisions and directives. The results of our 1986 efforts to bring unneeded discrimination rules to employee health plans has resulted in an embarrassment to this committee and an outcry from the backbone of this country—the business community.

As we are all well aware, Section 89 was included in Tax Reform Act of 1986 as an attempt to impose nondiscrimination and qualification rules with respect to certain employer-provided benefits. These provisions were modified in the Technical and Miscellaneous Revenue Act of 1988. In 1989, just three years after the implementation of Section 89, a mere 122 days after these misguided provisions were enacted, and 62 days after the release of the Internal Revenue Service Notice of Proposed Rulemaking, we are now considering a massive overhaul of nondiscrimination rules.

The problems with section 89 are numerous and complex. Exemplifying just one example of the problems faced by employers with the enactment of Section 89, is the limited resources of small businesses and associations. The Internal Revenue Service estimates it will take up to forty-four hours per year for an employer to learn the provisos of Section 89, qualify his plans and apply them as a test for discriminatory practices. Most small businesses and associations will be forced to hire additional consultants to endure this task for them simply because they do not have the technical resources necessary to complete such an immense endeavor. Time and expense dictated by this process will be detrimental and will ultimately lower the

taxable income of the employer for the year. A lower tax base will result in lost revenues and, with the critical status of our nation's budget deficit, a rule that was purportedly designed to raise revenues will ultimately constitute a revenue loser.

It is these problems and complications that have led to near revolt of the business community and prompted the great concern of the Members of this great body. I have personally taken great interest in the intricate maze of Section 89 and have worked vigorously to air the justified complaints of the business community. On January 19th of this year, I introduced the first of two bills designed to breach the problems of Section 89. The first of these bills, H.R. 518, was the first Section 89 bill introduced in the 101st Congress. It was a simple bill that requested a delay of the effective date of Section 89 until January 1, 1990, providing some relief to businesses. Senator Steven Symms of Idaho introduced the Senate counterpart. H.R. 518 garnered over 130 bipartisan cosponsors, including 10 of my colleagues on the minority side of Ways and Means.

On January 24, 1989, Congressman John LaFalce introduced a bill that garnered close to 300 cosponsors. The bill, H.R. 634 would repeal Section 89. The business community, led by the National Federation of Independent Business and the U.S. Chamber of Commerce, mobilized to bring this bill the substantial support it has mustered. Senator Trent Lott introduced the Senate companion bill. After much thought and input from the many firms affected by our attempt to add nondiscrimination rules to the tax code, a series of Section 89 reform bills were introduced including two in the Senate—S. 595 introduced by Senator Pete Domenici, and S. 654 introduced by Senator David Pryor—and two in the House. The pretext of today's hearing is to discuss the options that the Members of Congress have in reforming Section 89. Mr. Chairman, I too am a sponsor of a reform bill of my own design, H.R. 1682, a bill that was introduced April 5. The one common issue touted by all these reform bills is the need to view them as discussion-oriented legislation. I heartily commend you Mr. Chairman, for understanding the need to discuss the issue in an open forum such as today's hearing.

The ideas I wish to address today are included in H.R. 1682, a bill I introduced to provide an open discussion regarding the options for transforming Section 89 into a manageable directive that will receive the support of the business community. H.R. 1682 is a compilation of corrections to Section 89 borne of ideas set forth by numerous representatives of all aspects of the business community. There are five major sections of H.R. 1682:

(1) Elimination of all tests except the 80% test which would be reduced to a 70% test. The 70% test has been included to meet the need for a simpler test that would allow for broader compliance. This eliminates the need to run many costly and time-consuming tests to determine compliance.

(2) Exclusion from the test of employees who normally work less than thirty-five hours per week. One of the biggest problems with the Section 89 regulations is the perception that a part-time employee is always entitled to the same benefits as a full-time employee. The added cost of including part-time employees will dictate the elimination of many part-time and temporary jobs. The elimination of those jobs can only reduce payroll taxes, increase costs to government need programs, and increase unemployment.

(3) Exclusion from the test of leased employees, union employees covered by a collective bargaining agreements, mandatory retirees, and enrollees covered under the Older American Community Service Employment Act. Once again, as in the situation involving part-time employees, the use of leased employees and enrollees will precipitate the elimination of these types of employment opportunities. Union employees covered by collective bargaining agreements already have benefit plans that they have agreed to in principle, so their inclusion in Section 89 will unnecessarily increase the cost to the business. Mandatory retirees who are by law required to terminate employment will also be exempted from the test.

(4) The penalties associated with a violation of Section 89 would not exceed the cost of such benefit to the employer. This provision would squarely place the blame for the violation where it belongs—on the employer. Most representatives of the business community have supported this provision. The penalties would also not exceed the cost to the employer of providing the benefit. It was a gross mistake to include in the taxable income the received benefit that is provided to the employee. We all have heard the potential horror stories about an individual who receives heart surgery at a cost of $100,000 and how this forces his income for the year into a drastically higher tax bracket. This provision would place the costs where they belong: in the hands of the business itself.

(5) The most important signal we can send to the many affected by Section 89 is the desire for this committee to understand our abilities and to reaffirm our desire to work with them for a more palatable means of regulating nondiscriminatory benefit regulations. By incorporating a delay of the enforcement of Section 89 until January 1, 1990, we say to the business community, "we understand that we have been making much I needed corrections to the egregious provisions of Section 89 and, while we continue to pursue more workable provisions, we believe it is in the best interest of everyone to push compliance into the future." Any major changes to Section 89 require a delay to allow the Department of the Treasury to produce needed regulations in a timely manner, allow businesses to make needed adjustments, and allow the members of this body to understand what they have enacted.

Mr. Chairman, I have presented to this committee a position that is designed to heighten the discussion of reform for Section 89. It is imperative that we move to a position that will allow the business community to comply without undue hardship, expense and paperwork. I have stated the need for a delay as an affirmation to those affected by Section 89 that we hear their concerns and want to help. It is vital that we do not let this moment escape us by failing to make a serious attempt to reform Section 89. Mr. Chairman, once again I commend you for your timely call for these most important hearings. From the number of organizations, associations and individuals who have requested to address this body, the importance of the issue is obvious.

Statement of the Edison Electric Institute

Mr. Chairman and members of the Committee, the Edison Electric Institute (EEI) appreciates the opportunity to present our views on section 89.

EEI is the association of electric companies. Its members serve 97 percent of all customers served by the investor-owned segment of the industry. EEI members generate approximately 77 percent of all electricity in the country and provide electric service to 73 percent of the nation's ultimate electricity customers.

Mr. Chairman, the current section 89 requirements are simply too confusing and are difficult to administer for even the most sophisticated employer. We believe that the severe administrative burdens of complying with current law can be reduced and much fairer treatment of employees will result if a number of fundamental changes are made to section 89.

TESTING BASED ON AVAILABILITY

The most significant concern of EEI relates to the general testing methodology within section 89. Most electric utilities have a health-care program that is available on a very broad basis, generally to all of their employees—executives, middle management, and rank-and-file. Obviously, under such arrangements, there is no discrimination among classes of employees. Modifying section 89 to include a testing procedure that looks to availability for health-care benefits and not to the benefits elected or received by employees, will result in a uniform framework which will be both fair and appropriate.

LEASED EMPLOYEE RULES

Another significant concern of eel relates to the treatment of leased employees. Current law should be modified to include a safe harbor with respect to leased employees. Further, we believe that the determination of whether a leased employee is eligible for a health-care program should be placed at the leasing organization level. Such an approach, however, would require a reasonable period of transition in order to be workable. Providing transition rules will allow an adequate period of time to modify existing contractual arrangements.

The elements of such a transition period would include, in our view, the following:

(1) An overall moratorium on the application of the leased employee rules under section 89 for the year 1989.

(2) The application of the leased employee rules for the year 1990 based upon the availability of a core health plan, whether or not such plan meets specific qualification rules.

In addition to the recommended transition period, we also believe that any safe harbor for certain leased employees should allow for the exclusion of any leased employee if the leasing organization makes available to its employees affordable core health care benefits.

SALARY REDUCTION

Any benefits test should be designed to ensure that highly-compensated employees do not receive a disproportionately higher level of employer-provided benefits than are made available to rank-and-file employees. We recommend that any proposed benefits test be designed so that salary reductions are treated as employee contributions for both highly compensated and non-highly compensated employees and that employers be allowed to continue to choose to test dependent care assistance programs under either section 89 or section 129 as allowed by current law. This will avoid the inequities and distortions that will occur if salary reduction amounts are treated as employer-provided benefits. In addition, because the group of employees that are considered highly-compensated can include many employees covered under a collective bargaining agreement, this limitation can hurt the rank-and-file employees who it expressly was designed to help. In fact, in many instances, a cafeteria plan was adopted as a product of collective bargaining. We believe equal treatment of all employees for purposes of this test is appropriate.

COLLECTIVELY-BARGAINED EMPLOYEES VS. ENTIRE WORKFORCE

Mr. Chairman, certain proposals which have been made to modify the provisions of section 89 would require separate testing of employees included in a qualified bargaining unit. Under these proposals, that rule would be applied in all situations, even where the same core health-care plan is available both to union and to non-union employees.

One of the principal changes sought in modifying section 89 is the need for simplification. Requiring that an employer with collectively-bargained employees must maintain two distinct procedures for the operation of section 89 results in more complexity rather than simplicity. Both collectively-bargained employees and employers would be better served if this provision were made elective.

Mr. Chairman, we are pleased to have the opportunity to present our views on the need to simplify and make more equitable the nondiscrimination rules of section 89.

STATEMENT OF THE ENTREPRENEURS OF AMERICA

(SUBMITTED BY TED NICHOLAS, PRESIDENT, ENTREPRENEURS OF AMERICA)

Entrepreneurs of America is a business resource network representing approximately one million entrepreneurs across the country. As founder and president of Entrepreneurs of America, I strongly urge Congress to repeal, not modify, Section 89 of the Internal Revenue Code.

We commend the Senate Finance Committee for being concerned about Section 89 and examining the effects it will have on our economy.

Enacted as part of the Tax Reform Act of 1986, Section 89 was presumably intended to ensure that employee benefit plans do not discriminate in favor of higher-salaried employees. The law requires employers to administer complicated non-discriminatory tests for benefit plans and to follow qualification rules, a process that is costly and time consuming. The result has been that many small businesses have decided to drop benefit plans altogether rather than spend the time and money trying to understand how to comply.

Most businesses were unaware of Section 89 until word spread throughout the business community early this year. It was very disturbing for our members to learn of the new law which was effective January 1 of this year, regulations for which were not issued by the Treasury Department until March due to its complexity. Since that time Treasury has delayed implementation of the compliance testing and penalization period and Congress is considering legislation to simplify the law, all of which is even more confusing to business owners who must plan their benefit plans well in advance and are uncertain at this point what they should do.

The biggest losers in this process are the workers who are losing much-needed health benefits as a result of excessive and burdensome government regulation. This is the opposite of the original intention of Members of Congress who are concerned that employees receive more health benefits rather than having their plans canceled.

Section 89 would tax benefits found to be excessive under complicated rules. We at Entrepreneurs of America are strongly opposed to a tab on benefits, which we feel runs contrary to the message Americans sent to Washington with the last election—no new taxes! We also believe there was no basis to pass such legislation to begin with. The economic requirements within a free market should determine the

salary and benefits provided to employees based on their contribution to the business. A competitive business enterprise needs to be able to treat each person and their contribution to its activities individually.

Small business owners want to provide benefit packages that are competitive with large corporations in order to attract experienced, competent employees. Many of these businesses will be forced to eliminate coverage because of the complications created by Section 89.

Those who intended Section 89 to be a revenue raiser should know that the exorbitant costs will offset the taxes collected. Some experts have estimated that billions of dollars will be spent by businesses to hire outside consultants to help bring them into compliance, all of which is tax deductible. The net result will not be an increase in federal revenue, but rather a decrease.

Small business is the nation's largest employer and the lifeblood of our economy. Congress needs to help small business instead of passing legislation discouraging entrepreneurship.

Entrepreneurs of America feels that Section 89 is a mistake that Congress needs to correct and the only solution is to repeal the law. Simplification only creates more confusion in the business community and the end result is government regulations that stifle business and productivity.

FOSTER & GALLAGHER, INC.

May 1, 1989.

LAURA WILCOX,
Hearing Administrator,
U.S. Senate Committee on Finance,
Dirksen Senate Office Building,
Washington, DC.

Dear Ms. Wilcox: We would like to voice, for the record, our support for measures to simplify or repeal Section 89.

The benefits package we provide to our employees is fair and nondiscriminatory. However, due to the nature of our business, Section 89 imposes an inordinate administrative burden which can only raise the cost of employee benefits and limit future expansion of our benefits package.

We trust that common sense will prevail in this matter and that Congress will expeditiously modify this legislation.

Thank you for this opportunity to be heard.

Very truly yours,

MICHAEL F. NORBUTAS, *Treasurer.*

STATEMENT OF FRIEDMAN & FULLER

Thank you for this opportunity to present my views on the impending implementation of Section 89. My name is Barry Benz. I am a Certified Public Accountant and Senior Manager in the Tax Department of Friedman & Fuller, P.C., a public accounting and management consulting firm based here in the Washington, DC, metropolitan area.

I would like to restrict my testimony to two key areas: the effects Section 89 will have on small business and some of the unintended consequences the rules will bring about. Our clients tend to be small- to medium-sized firms, often family-owned. If Section 89 is implemented, it will impose devastating paperwork and compliance costs on most of our clients. Many of our clients are in the wholesale-distribution industry, one not known for large profit margins.

Compliance with Section 89 is no simple task. Most small businesses do not have the internal resources to comply with the rules. This will force companies to turn to outside advisors to compile the necessary information and perform the discrimination tests. A typical fee for these services is $2,500, plus $10 per employee. This will be a recurring yearly fee, not a one-time charge. These compliance services will do nothing to bolster American competitiveness and productivity, but rather will only serve to bury businesses under the ever-increasing mound of needless paperwork.

The intent of the legislation was to give employers the choice to have highly compensated workers pay taxes on discriminatory benefits or to provide comparable benefits to enough workers in order to pass the discrimination test. Employers who fail the discrimination test will find the additional cost to provide more benefits to a

broader base of workers to be prohibitive. Small business cannot and will not absorb these costs.

Because providing additional benefits to a broader base of employees is not a viable alternative for many small businesses, the highly compensated employees of these businesses will face higher tax bills. I suggest to you that these increased tax liabilities will not be funded by the highly compensated employees, but rather will be funded by the same non-highly compensated employees Section 89 intended to help. Privately, many companies have already made the decision to counteract any increased tax liabilities. In a competitive marketplace this will be necessary to keep these key employees—who, because of their specialized skills, are extremely difficult to replace.

Under this scenario, the net effect for the highly compensated will be nil. However, businesses will have to fund these higher salaries. Absent the ability to raise prices, the impact of the funding will fall on non-highly compensated employees, by way of smaller salary increases, a decrease in employer-funded benefits, or termination of marginal employees. Small businesses do not have the luxury of being able to shift resources to comply with Section 89.

The goal of trying to increase health and life insurance coverage for a larger percentage of working people is laudable. Section 89, despite the good intentions behind it, will prove to be a poor method for bringing about that goal. In the business world successful companies do not throw good money after bad on a product that just won't sell. Government must learn this lesson from business and repeal Section 89.

Thank you for this opportunity to express my views on this matter.

E.W. HARRIS

April 6, 1989.

Senator PETE DOMENICI,
Senate Dirksen Building,
Washington, DC.

Dear Sir: I am responding to your recent bulk mailing concerning your S. 595.

In 1956 I bought a small business in Farmington, operated it until January of 1988. In 1979 I established a retirement program which covered all of the seven or eight employees of the business. Almost immediately I saw the paper work could not be handled by me and a service in California was paid to do the work.

The cost in both my time and in money became more than I felt the program justified and I closed the whole thing out in 1984. I suspect the abuses of such plans by corrupt union people back east may have been the reason for the restrictive legislation, but I just couldn't afford to continue the program. It is my understanding that many small employers arrived at the same conclusion.

At the present time the business offers no fringe benefits of any kind to the employees. The laws are too complicated, the penalties and risks of penalties are too high.

Thank you for asking my opinion.

Sincerely,

E.W. HARRIS

HERSHEY FOODS CORPORATION

Hon. LLOYD BENTSEN,
U.S. Senate,
Washington, DC.

Dear Senator Bentsen: Hershey Foods commends the efforts you have made to date to simplify section 89 and thereby lessen the compliance burden for employers. In the hope of assisting you in this endeavor, we have attached a copy of comments which we recently submitted to the Senate Finance Committee for the record.

Our comments include concerns which we hope you will take into consideration as you continue to work on solving the problems raised by section 89. Some of the proposals now under consideration do much to simplify the laws' complex testing procedures, for example, but they create new problems by drastically curtailing employers' ability to offer multiple options plans.

Our employees have welcomed the freedom which our flexible benefits plans have given them to select those benefits which best fulfill their individual needs, and we hope that any solutions the committee adopts will preserve this freedom of choice.

Thank you for this opportunity to share our thoughts and concerns with you. Should you have any comments or questions, please feel free to call me, or Angela Kurtz in my office, at (202) 223-9070.

Sincerely,

HOLLY HASSETT, *Manager, Washington Office.*

COMMENTS TO SENATE FINANCE COMMITTEE RE: SECTION 89

Hershey Foods Corporation fully supports the principle of nondiscrimination in employee benefits. However, we do not support the use of complex testing procedures costing tens of thousands of dollars to uphold such a principle when more efficient, less costly means are available. We therefore applaud the action of the Finance Committee in soliciting comment for simplification of that portion of the 1986 Act.

Hershey Foods Corporation is a typical example of the many employers throughout the nation who provide similar coverage to all of their employees. Section 89, however, assumes *by definition* that such employers are atypical. All employers are assumed to be guilty of discriminatory policies until proven innocent. They are punished for the hypothetical discrimination of a select few by way of burdensome testing procedures which consume enormous amounts of their time, money and energy. In a period of worsening trade deficits and shrinking markets, it is important to emphasize that the less time employers spend on compliance with unproductive regulations, the more they can devote to increasing US competitiveness.

The complexity of Section 89's testing provisions is exacerbated by its use of definitions which have no bearing on the actual benefits plans. This language merely serves to confuse employers. It also creates a very distorted image of many equitable and generous benefits programs.

Some proposals now under consideration in Congress do go a long way towards providing relief in these areas. Limiting the number of tests, changing the definition of part-time employees and excluding collectively bargained plans—to give some examples—are all welcome steps. At the same time, some of these same proposals run directly counter to section 89's goals of expanded coverage and improved health care in that they drastically curtail an employer's ability to offer employees choices among various plans or benefits. We trust that this is an unintended side effect of an otherwise laudable attempt to make Section 89 both meaningful and manageable.

Currently all of Hershey Foods Corporation's salaried employees, from the Chief Executive Officer to the mail room clerks, are covered by a flexible benefit program providing significant choices for employees in the medical, life insurance and disability insurance areas. In addition, most of our hourly employees also enjoy availability of two or more health plan options.

Hershey adopted these cafeteria plans to respond to the needs of our work force in a changing environment. Traditionally, our plans have been completely nondiscriminatory. In designing our multiple option plans, we made sure that they would not discriminate in favor of any group of employees, highly compensated or non-highly compensated.

Moreover, as the Company assumes most of the cost of the plans, non-highly compensated employees can afford to choose the same coverage as highly compensated employees regardless of their pay levels. In other words, our plans treat all employees alike. For instance, flexible credits for medical coverage are based solely on family status so employees get exactly the same number of credits whether they are senior executives or clerks.

When we introduced our cafeteria plan in 1988, all eligible employees were given sufficient flexible credits to permit them to completely replicate the benefits they had enjoyed in the previous year. similarly when flexible credits were assigned for 1989, we continued to provide sufficient credits for employees to continue their preceding year's coverages. These flexible credits (whether or not they are convertible into cash) are employer contributions above and beyond an employee's standard salary. They are to purchase health insurance and other benefits. These are in no way "Salary Reduction" since they were never part of employee salaries. Rather, flexible credits are simply a different way of providing employee benefits, permitting employees the opportunity to choose only those coverages which meet their needs.

Unless this distinction is made clear, the freedom of choice available to both highly compensated and non-highly compensated employees will be restricted. Em-

INTENTIONAL
BLANK

ployees will be foreclosed from choosing the benefit mix most appropriate to their individual circumstances.

We urge the Members of the Finance Committee to continue to seek means to simplify Section 89 so that employee benefit plans can continue to perform their task of providing a choice of benefit arrangements for all employees so that they can best secure their continued health and well-being.

STATMENT OF INTERNATIONAL UNION, UNITED AUTOMOBILE, AEROSPACE & AGRICULTURAL IMPLEMENT WORKERS OF AMERICA (UAW)

This statement is submitted on behalf of the International Union, United Automobile, Aerospace and Agricultural Implement Workers of America (UAW). The UAW represents 1.5 million active and retired workers, most of whom are covered under negotiated health benefit plans.

The UAW has been a leader in negotiating health care benefits for rank-and-file workers. Our negotiated health benefits plans typically provide the same benefits or benefit options to all workers covered under our bargaining agreements, and to their families. However, we recognize that many employers—especially those with non-union workforces—do not offer any health insurance coverage to their workers, or else only offer benefits to a select group of highly-compensated employees.

The UAW remains firmly committed to the principle that all Americans should be entitled to health care as a basic social right. That is why we have consistently championed the establishment of a national health care program, with universal coverage, comprehensive benefits, and strict cost containment and quality assurance provisions.

One important step toward the goal of universal health insurance coverage would be to expand employer-provided health insurance coverage. Although employer-sponsored health care plans form the bedrock of our existing health care system, approximately four of every five of the 37 million people who lack health insurance coverage are working men and women, or their dependents. To address this fundamental problem, the UAW has supported legislation which would require all employers to provide at least a minimum package of health benefits to workers and their families, such as the proposed Basic Health Benefits For All Americans Act of 1989 (S. 768) which has been introduced by Senator Kennedy. The approach adopted in this legislation would represent the best method of expanding health insurance coverage under employer-sponsored health care plans and it deserves broad support.

Consistent with this important goal of expanding access to health care, the UAW also supported the enactment of the Section 89 non-discrimination rules as part of the Tax Reform Act of 1986. In our judgment, these non-discrimination rules were needed to ensure that the health care benefits provided by employers are actually available to a broad cross-section of workers, not just a few highly-compensated employees. We have traditionally supported the principle that the granting of tax-favored status to employee benefits should be conditioned on the observance of non-discrimination rules. This principle has long been incorporated in the laws relating to employer-provided pension benefits. The UAW believes that the same principle should be equally applicable to employer-provided health care benefits.

However, we recognize that the existing rules under Section 89 are overly complex and potentially burdensome for some employers. Much of the complexity consists of numerous loopholes and "safe harbors" which enable various employers to avoid having to provide roughly equivalent health care benefits for all employees. That complexity also needlessly increases compliance costs because employers will hire expensive benefit consultants in order to understand, and often exploit, the labyrinth of Section 89 regulations. The money spent on these consultants would be much better spent on providing real health care benefits to workers and their families.

The current Section 89 rules also have a serious flaw which could result in the painfully ironic situation whereby *all* of a firm's "highly compensated employees" could be exposed to tax penalties, including those *employees who had no control over the behavior of the employer in setting up the discriminatory plan and who reaped none of the benefits from the discriminatory plan.* The most obvious example of this legislative flaw would involve exposure of a relatively well-paid and high-overtime worker covered under a negotiated health plan to tax penalties because the employer set up a separate, discriminatory health plan for its salaried workers. That would be clearly illogical and unfair, but it is a possibility under current law. In a more general sense, the principle in Section 89 of subjecting *employees* to various tax pen-

alties because of an *employer's* discriminatory conduct is simply unfair to all workers.

Senator Pryor has introduced legislation (S. 654) which would make a number of changes in the Section 89 non-discrimination rules. The provision creating an additional safe harbor for "simplified health arrangements" does contain some positive elements. In particular, the 90 percent coverage test, combined with the plan design requirements which I limit employee premiums and which require equal employer contributions on behalf of all employees, represents a workable approach which could greatly reduce administrative burdens while preserving the principle of nor-discrimination. However, we believe that this type of approach should be applied to all employer-sponsored health plans, instead of simply being an additional safe harbor for "simplified health arrangements." The plan design standards, which promote access to affordable health care, are simply too important to be so narrowly applied. Further, the proliferation of safe harbors will increase the complexity of the non-discrimination rules and the costs of compliance, thus draining funds which could be better spent on providing health care protection to workers and their families. The plan design standards in S. 654 should be improved by establishing reasonable levels for deductibles, coinsurance and maximum out-of-pocket expenses to further limit cost sharing by employees. The limits on employee premiums should also be indexed according to the "Average Weekly Earnings of Production and Non-Supervisory Workers on Private, Non-Agricultural Payrolls," rather than a general inflation measure such as the CPI–U.

The UAW is also concerned that the bill does not take any steps to address the fundamental problem under Section 89 of employees being penalized for the discriminatory conduct of their employer. The Pryor bill still places the penalty for non-compliance with Section 89 on employees. No provision is made for separate testing of collectively bargained health plans. Thus, relatively well-paid, high-overtime workers covered under a negotiated health plan could still be subjected to tax penalties in situations where their employer has established a separate, discriminatory health plan for salaried workers. We believe that any legislation to reform Section 89 must address this fundamental inequity.

The UAW is also troubled by several other provisions in S. 654. In particular, we are concerned that the proposal to exempt part-time employees working up to 30 hours a week (this threshold would gradually be based down to 25 hours per week) would exclude the very workers who are most likely to be discriminated against and who need the protection offered by Section 89.

We are also concerned about the provision which would expand the permissible disparity in employee-paid premiums among various health plan options from $100 to $365 per year under the alternative 80 percent coverage safe harbor in current law. This would simply enlarge a loophole in existing law, thereby depriving additional workers of the protection afforded by Section 89.

Chairman Rostenkowski has also introduced legislation (H.R. 1864) to simplify the non-discrimination rules under Section 89. The UAW generally supports the framework of this legislation. We believe that H.R. 1864 would continue to foster the underlying objective of non-discrimination in employee benefits, while at the same time greatly reducing the administrative burdens on employers under Section 89.

In lieu of the multitude of existing tests, H.R. 1864 would establish a simple, two-pronged test. An employer's health benefit program would pass this test and be considered non-discriminatory if:

- health insurance coverage is available to at least 90 percent of the employer's rank-and-file employees, and the premiums which employees are required to pay under such coverage do not exceed $10 per week for individual coverage and $25 per week for family coverage; and
- the maximum amount of premiums paid by the employer on behalf of any highly-compensated employee does not exceed 133 percent of the premiums paid by the employer under the health insurance coverage which is available to 90 percent of the rank-and-file employees.

While we have several recommendations for reducing the levels of cost-sharing and narrowing the permissible range of premiums paid on behalf of highly compensated and non-highly compensated employees, the UAW finds that the general framework of the bill provides a good, workable basis for meeting the legitimate non-discrimination goals of Section 89. Specifically, the 90 percent coverage test would do much to ensure that most rank-and-file workers are eligible to participate in an employer's health benefit programs, a fundamental protection which non-unionized workers simply do not have widely available. The addition of a "plan design standard" which limits a worker's cost-sharing for individual and family medical care is a very sound idea and one of the most notable improvements over current law. The princi-

ple of comparing the value of the health care program offered to privileged employees to that offered to rank-and-file workers is preserved in the bill. These three principles—equal access, affordability and similar contributions for all employees are central to the non- discrimination goals of Congress in establishing Section 89.

The two-pronged test set forth in H.R. 1864 has a number of important advantages over the existing non-discrimination rules. The new test is much less complicated, and hence could easily be performed "in-house" by employers, without having to resort to expensive benefit consultants. This preserves dollars for health care benefits for people, rather than simply adding administrative costs. These new standards would eliminate the need for employers to conduct complicated, costly tests procedures to make sure that rank-and-file employees are actually participating in the employer's health benefit program. There would not be any need to determine the family status of employees, or to collect affidavits on whether workers and their dependents have coverage elsewhere. The new test also allows employers to focus on the premiums paid by employers and employees for health coverage, rather than the "actuarial value" of the benefits. In general, employers would be able to look at their entire health benefit program in the aggregate, without having to separately test different benefit plans and options.

Employers which are providing health care benefits on a truly non-discriminatory basis should have no difficulty in passing the tests set forth in H.R. 1864, and they should be able to determine this easily, without resorting to undue expense and administrative burdens.

In addition to establishing a new two-pronged test for discrimination, the legislation introduced by Chairman Rostenkowski provides one possible approach to correcting the flaw in current law which could penalize certain unionized workers who were obviously not responsible for the employer's discriminatory behavior and who reaped no benefit from it. The bill corrects this flaw by providing that employees included in any "qualified bargaining unit" shall be tested separately in applying the non-discrimination rules under Section 89. The UAW believes that this is a workable approach, in light of the fact than the tax penalties for non-compliance with the non-discrimination rules—bath under existing law and under H.R. 1864—are levied against employees, rather than employers. As long as this remains the case, the UAW strongly opposes any effort to include unionized workers with the rest of an employer's workforce for purposes of applying the Section 89 non-discrimination tests. We believe, however, that other approaches to the general problem of setting a fair standard for the application of Section 89 tax penalties should be examined.

As a general principle, the UAW believes that employers ought to be required to pay any tax penalties for non-compliance with the non-discrimination rules, not employees. After all, it is the employer who is responsible for establishing and administering the health care program. If that program is discriminatory, the employer is the guilty party. The employees are blameless, and should not be required to pay for the employer's discriminatory conduct.

Imposing a tax penalty on the employer would be entirely consistent with the basic principle underlying Section 89 namely, that health care benefits should be granted tax-favored status only if they are provided on a non-discriminatory basis. If a health benefit program is discriminatory, its tax-favored status can be reduced or eliminated by imposing an excise tax on the employer for the portion of the health care payments which are discriminatory. It is not necessary to make workers pay taxes on their benefits in order to accomplish the non-discrimination goals of Section 89.

The legislation introduced by Chairman Rostenkowski recognizes this principle in connection with the penalties for failure to satisfy the "qualification" rules under Section 89. Under present law, if a plan fails the qualification rules all employees are taxed on the entire value of their health care benefits. As indicated by Chairman Rostenkowski in his floor statement, "This sanction is unfair because it penalizes employees who have no control over the failure to satisfy the rules." H.R. 1864, therefore, replaces this sanction with an excise tax on the employer.

The UAW is pleased that H.R. 1864 puts this sanction where it belongs—on the employer. We believe that a similar approach could and should be adopted with respect to the penalty for non-compliance with the non-discrimination rules under Section 89. However, so long as the tax penalty remains on employees, we believe that collectively bargained health care plans should be tested separately. If the health benefits negotiated by a labor union for its members pass the non-discrimination tests standing on their own, it is simply unfair to penalize any union members for discriminatory conduct by the employer in connection with health benefit plans established by the employer for other workers. The mere fact that a few highly-

skilled union members, working long overtime hours, may earn enough to qualify as "highly compensated employees" under the statutory definition should not expose them to tax penalties because of the employer's discriminatory conduct. Another way to resolve this problem would be to simply exclude workers covered under a negotiated health program from the definition of "highly compensated employees" in the Internal Revenue Code.

If the provisions in H.R. 1864 requiring separate testing of employees covered by collectively bargained health care plans remain in the final bill, we believe that the definition of "collective bargaining unit" should be clarified. The blanket exclusion of employees performing services in the fields of health, law, engineering, etc. sweeps too broadly. We recognize that this provision is designed to prevent the establishment of abusive, sham bargaining arrangements by professional corporations in order to circumvent Section 89. But there are also many bona fide collective bargaining agreements covering workers in the field of health, law, and other areas. We believe a more narrowly-drafted provision could prevent sham arrangements without excluding bana fide bargaining arrangements.

The UAW believes that H.R. 1864 could be clarified or improved in a number of respects:

First, we are concerned that the employee premium levels established under the 90 percent coverage test are too high. Many low-wage workers simply cannot afford to pay $10 per week for individual coverage or $25 per week for family coverage. The $1300 annual limit on premium sharing in the current draft of H.R. 1864 amounts to a wage reduction of about 63 cents per hour. This would cause substantial hardship for mill ions of workers, especially those earning the minimum wage. In order to ensure that rank-and-file workers can actually afford to participate in the health care plans offered by their employer, these premium levels should be lowered substantially. Cost-sharing should be limited in other ways, as well, by including reasonable levels for maximum deductibles and coinsurance, along with a cap on overall out-of-pocket expenses. These kinds of internal cost-limiting devices would do much to improve needed access to health care.

Second, the indexing mechanism for the premium-sharing levels should be improved by substituting, for the Social Security measure of U.S. average wages, an index based on "Average Weekly Earnings of Production and Non-Supervisory Workers on Private, Non-Agricutural Payrolls." This is a standard Bureau of Labor Statistics series which is regularly published. It focuses on compensation for the very group of people most likely to have benefit plans with premium sharing—the non-supervisory workers. Since the Social Security measure embraces earnings of all workers, including supervisory employees and self-employed individuals, it would be a much poorer measure of the actual "ability-to pay" for the group of workers affected by premium sharing. The BLS standard also has advantages over some other federal statistical measures of taking into account changes in time actually worked and the share of part-time work in our overall economy. The UAW strongly opposes any effort to tie the premium-sharing levels to any index of medical inflation or underlying inflation rates. Since inflation in the health care industry has consistently outpaced increases in the general cost of living and increases in average wages, indexing the employee premium levels to medical inflation would greatly disadvantage rank-and-file workers. Over time, plans meeting the premium standards would actually become less and less affordable for low-wage workers. The use of any inflation-based standard (such as the CPI–U which is used in S. 654) would have similar results. Employers would be able to pass the non-discrimination tests by offering plans which were theoretically available to all employees, but which were actually affordable only for highly paid executives, not rank-and-file workers. It is very important to develop a fair indexing standard which recognizes that wages of lower-paid workers do not rise as fast as wages for affluent workers. Economy-wide *averages* therefore, distort the true picture of the economic position held by lower-paid workers over time.

Third, we urge the Committee to use this same guiding principle of "ability-to pay" in establishing the premium, deductible or coinsurance limits for retired workers and their families. Retirees simply don't have the same money incomes as workers and cannot afford heavy cost-sharing amounts. In addition, since most retirees have Medicare coverages, the total cost to the employer of health care for those retired families is smaller than it is for an active worker. Unless separate limits are developed for such retirees, the bill could have the unintended effect of shifting *all* of the costs of Medicare-complementary coverages to retirees, leaving the employer in a better position than before and placing unbearable burdens on retired workers.

Fourth, the UAW believes that the standard which permits premiums paid by employers for highly compensated employees to be 133 percent of the premiums paid

for plans generally available to non-highly compensated workers is much too high. We urge the Committee to re-examine this standard and to reduce the permissible premium range to 120 percent.

Fifth, we urge the Committee to re-examine the penalties for failure to pass the non-discrimination tests, and to require employers, who are responsible for any discrimination built into the design of their health care programs, to pay any tax penalties associated with such failures.

Sixth, the UAW is troubled by the provisions of H.R. 1864 which would increase the threshold for covering part-time employees from 17.5 hours to 25 hours per week. This provision would exclude many part-time workers—the very workers who are most likely to he discriminated against and who need the protection afforded by Section 89. At the very least, we suggest that this 25-hour threshold should be reduced to 20 hours.

Finally, we believe it is important for the Committee to consider now the unique problems in developing a fair measure for testing for discrimination among retiree groups and among laid-off workers. Although retirees and laid-off workers could both be considered "former employees" under H.R. 1864, we believe they should be tested separately because of the significant differences between these two groups. In addition, it is unclear whether retirees and laid-off workers covered under negotiated health programs are to be tested separately. This should be clarified.

In its present form, H.R. 1864 also does not really speak to the issue of developing a reasonable benchmark for comparison of health benefit plans for noryhighly compensated and highly-compensated retirees. In many instances, the scope and level of health benefits may be quite different among an employer's entire population of retirees, with benefits anchored in the plan design in effect at the time the person retired. In this way, an employer's health program for all retirees (regardless of income levels) actually is a collection of many health programs, with different benefit structures and costs. We are concerned that simply viewing the entire retiree population as one group for purposes of the non-discrimination tests would ignore this diversity in health benefits and costs and perhaps give employers a significant loophole through which to evade the Section 89 non-discrimination tests. That is, if the rules for testing permit the aggregation of cost-sharing and premium values over the whole retiree population in some sort of composite way, the unintended result may well be to disguise more recent benefit and cost changes which could be discriminatory, standing alone, but which are hidden because of their inclusion in the values calculated for the entire retiree group. It is also important for the Committee to craft special Section 89 rules for retiree groups which acknowledge the fact that many retirees are eligible for Medicare and that there are significant cost differences between Medicare-complementary coverages and standard coverages. This should be considered in applying the non-discrimination standard under H.R. 1864 for the permissible range of premiums paid on behalf of highly compensated and non-highly compensated retirees. Thus, we urge the Committee to examine these issues carefully and to develop a non-discrimination standard for retirees which recognizes the diversity among retiree cohorts and which also recognizes the relative numbers of Medicare-eligible retirees in the employer's health programs.

The UAW believes that H.R. 1864 represents a significant improvement in Section 89. It would greatly simplify the non-discrimination tests, thereby reducing the cost and administrative burdens on employers. At the same time, it would continue the important principle of requiring employers who offer tax-favored health benefits to provide these benefits on a non-discriminatory basis to a broad cross-section of workers, not just to a select group of corporate executives. The UAW supports the general principles underlying H.R. 1864 and urges the Committee to consider our recommendations for improving and clarifying this bill.

The UAW appreciates this opportunity to present our views on the Section 89 non-discrimination rules. We look forward to working with the Chairman and other Members of the Finance Committee as they consider this important subject.

LAMSKE INVESTMENTS

Senator PETE DOMENICI,
Dirksen Senate Office Bldg.,
Washington, DC.

Senator JEFF BINGAMAN,
Hart Senate Office Bldg.,
Washington, DC

Representative JOE SKEEN,
Longworth House Office Bldg.,
Washington, DC.

I strongly urge you to support legislation to repeal Section 89 of the Internal Revenue Code. Such legislation has been introduced by Representative John LaFalce (D–N.Y.) in H.R. 634. S. 350 also repeals this regulation, which if left in place will be harmful to business and employees.

The intent of the supporters of Section 89 was to extend benefits to lower income employees who have not be afforded benefits such as health insurance in the past. The Joint Committee on Taxation stated that these rules should require employers to cover non-highly compensated employees to an extent comparable to that of highly compensated employees. This aim could be construed by some to be in the best interests of American people. However, the real effect of this confusing regulation is going to have the opposite effect.

Employers, particularly small businesses such as mine, cannot afford section 89. The cost of providing insurance, particularly health insurance, to any employees has become prohibitive to many businesses. To make it mandatory to extend these benefits to employees working as little as 17.5 hours a week could force many of us to drop coverage all together.

Perhaps the most ludicrous attribute of section 89 is the cost that will be associated with compliance testing. This regulation is so complicated that the IRS had not even been able to issue regulations to explain the law until two weeks ago, even though compliance was to have been required as of January 1. Very few accountants, insurance experts, or other professionals who might be available to help us struggle through the complex testing requirements have enough knowledge at this point in time to be of any service. Once they have acquire the ability to be of service, the cost to many businesses will be prohibitive. It other reason for dropping all coverages.

Please consider supporting business as well as the employees. The problem of inadequate health insurance is not going to be solved by Section 89. Many other problems will be created.

STATEMENT OF THE LOS ANGELES COUNTY BAR ASSOCIATION, SECTION OF TAXATION [1]

1. GENERAL DESCRIPTION OF H.R. 1864

H.R. 1864 would replace the current Section 89 nondiscrimination rules for health plans with a single simplified test. In general, an employer's health plan would pass the bill's test if the plan is not discriminatory on its face and:

(A) at least one plan or a group of plans providing primarily core health coverage is available to at least 90 percent of the employer's nonhighly compensated employees at an employee cost of no more than $10.00 per week in the case of individual coverage, or $25.00 per week in the case of family coverage, and

(B) the maximum amount of employer-paid premium that may be excluded from the income of any highly compensated employee is not more than 133 percent of the employer-paid premium made available to 90 percent of the nonhighly compensated employees.

The first part of the test is referred to as the eligibility test, and the second part is referred to as the benefits test.

2. ELIGIBILITY TEST

If the employer fails to meet the eligibility test, then the value of all health coverage provided to highly compensated employees is includable in the taxable income of the highly compensated employees.

The limit on employee cost is intended to ensure that coverage is, in fact, available to employees. Without some limitation, there is a concern that an expensive plan could meet the eligibility requirements and yet fail to expand the availability

---

[1] The following comments represent the view of the members of the Taxation Section of the Los Angeles County Bar Association as determined by its Officers and Executive Committee. These comments were principally prepared by the officers of the Employee Benefits Committee of the Section comprised of Robert R. Johnson, Chair of the Committee; David E. Gordon, Past Chair of the Committee and Vice Chair of the Section; Mark J. Grushkin, Vice Chair of the Committee; Steven L. Guise, Secretary of the Committee; and Roland G. Simpson, Chair of the Legislation/Regulations/Government Liaison Subcommittee of the Employee Benefits Committee.

of coverage because of the unrealistic financial burden electing such coverage would place on nonhighly compensated employees.

Policy Comments on Eligibility Test

(A) Dollar Limits on Employee Cost

We believe the proposed maximum employee costs of $10 per week for individual coverage and $25 per week for family coverage are too low for many employers and represent a serious defect in H.R. 1864. For example, the cost to the employer of a single-employee basic core health insurance indemnity contract in Southern California averages about $45 per week, and the cost to the employer of an employee and family basic core health insurance indemnity contract in Southern California averages about $120 per week. The proposed limits on employee costs will make it impossible for many employers, which currently offer the same health plans to all employees, to satisfy the eligibility test, or will force these employers to redesign their plans.

An important shared objective of Congress and private employers is to control escalating medical costs. The present limits on employee costs in H.R. 1864 will interfere with this objective. One factor causing escalating medical costs is the ability of two-income families to "doubledip" (i.e., maintain duplicative coverage) under each spouse's health insurance coverage. Setting the maximum required employee contribution too low will not help to control this problem.

A solution would be to replace the maximum dollar limits on employee costs with maximum percentage limits. The percentage limits would measure the required employee costs as a percent of the total combined costs for the employer and employee. The maximum percentage allowed for employee costs should be substantially greater for family coverage than for employee only coverage. Otherwise, employers may determine to cut back or simply not to offer family coverage paid for by the employer. We recommend limits on employee costs of 25 percent of combined employer-employee costs for employee only coverage and 50 percent of combined employer-employee costs for family coverage.

Maximum percentage limits (rather than dollar limits) will better account for differences in medical costs in different geographic areas. They will, also, avoid the necessity for indexing the dollar limits and will make the eligibility test more workable for former employees. These issues are discussed below. A less desirable alternative solution, which will not solve as many problems as percentage limits, would be to increase the maximum dollar limits, particularly for family coverage.

In addition, the bill should provide an alternative test similar to existing Section 410(b)(1). The limits on employee costs are intended to ensure that coverage is, in fact, available to nonhighly compensated employees. The alternative test is proposed to give a choice to employers who have plans which do not meet the maximum limits. Under this alternative test such employers would not have to redesign their plans where they can demonstrate that a plan, in fact, covers a substantial percentage of nonhighly compensated employees. In applying the alternative test an employer should be permitted to elect to disregard any employee and/or his spouse and dependents (if any) who are covered by a health plan providing core benefits maintained by another employer. This would be analogous to current Section 89(g)(2)(A).

Recommended Statutory Language: Proposed Section 89(c)(2)

"(2) QUALIFIED CORE HEALTH PLAN.—For purposes of this section, the term 'qualified core health plan' means any health plan if—

(A) the employer-provided benefit under such plan primarily consists of core benefits, and

(B) such health plan *either (i)* does not require contributions by the employee in excess of *25 percent of the total contributions by the employer and employee* [$10.00 per week] *(50 percent of the total contributions by the employer and employee* [$25.00 per week] *in the case of family coverage) or (ii) benefits (a) at least 70 percent of employees who are not highly compensated employees or (b) a percentage of employees who are not highly compensated employees which is at least 70 percent of the percentage of highly compensated employees benefiting under the plan."* (New language is italic, and language to be deleted is in brackets.)

(B) Indexing

In H.R. 1864 the specified dollar amounts are indexed for wage growth based on the SSA Average Wage Index. However, medical costs historically have risen far more rapidly than wages. The cost of living adjustment should be based on some index of medical costs rather than wage growth, if maximum dollar limits on em-

ployee costs are retained. Otherwise the maximum dollar amounts will very soon be out of date.

(C) Leased Employees

A major difficulty will remain in applying the eligibility test in the case of leased employees. The data- gathering and administrative burden posed for large employers is unnecessary and disproportionate to any likely benefits.

We discuss the problem and our recommended solution below under the headings "Special Rules: (E) Leased Employees."

Technical Comment on Eligibility Test

"Core health plan" is not defined in H.R. 1864. It may be appropriate to define this term.

3. BENEFITS TEST

The purpose of the benefits test contained in H.R. 1864 is to ensure that highly compensated employees do not receive a disproportionately higher level of employer premium than the level of employer premium that is available to the nonhighly compensated employees. Under H.R. 1864, the maximum tax-favored-benefit that a highly compensated employee may receive is generally 133 percent of the smallest employer premium for the employee-only coverage that is taken into account in applying the 90 percent test. However, if a highly compensated employee elects family coverage, and if the employer maintains a plan that provides family coverage that meets the requirements under the bill for the 90 percent test, then the maximum tax-favored premium is increased to 133 percent of the smallest employer-paid family premium taken into account in applying the 90 percent test. Any employer-paid premium received by a highly compensated employee in excess of the level of employer-premium that meets the benefits requirement is includable in the taxable income of such employee.

Policy and Technical Comments on Benefits Test

We generally support the benefits test in H.R. 1864. However, as presently drafted, it contains potentially fatal defects.

First, the benefits test will not work for cafeteria plans when it is applied using the proposed special rule for salary reduction contributions. The result will be to kill cafeteria plans and flexible spending accounts through the back door of Section 89.

We think the problem in this regard is not with the benefits test, but rather is with the special rule for salary reduction contributions. We discuss the problem and our recommended solution below under the headings: "Special Rules: (A) Salary Reduction."

Another serious defect relates to the measurement of the taxable benefit. Proposed Section 89(b)(2)(A) provides as follows:

"(2) TAXABLE BENEFIT UNDER PLANS MEETING ELIGIBILITY REQUIREMENTS.—

(A) IN GENERAL.—The taxable benefit of any highly compensated employee under health plans meeting the requirements of subsection (c) is the excess (if any) of—

(i) such employee's aggregate employer-provided benefit under such plan, over

(ii) 133 percent of the amount which would have been such employee's employer-provided benefit if he had been a participant with the same status in the plan which was taken into account in determining whether the requirements of subsection (c)(1)(B) are met and which would result in the smallest employer-provided benefit determined for purposes of this clause."

The Floor Statement of Chairman Rostenkowski includes the following example:

"*Example 3.*—An employer maintains several health plans. Three plans are core health plans. Each core plan is available to over 90 percent of the nonhighly compensated employees. The employer cost of each of the three core planes is $500, $1,000 and $1,500 respectively. The maximum excludable benefit that may be received by any nonhighly compensated employee is $1,995 ($1,500 x 1.33). Thus, any highly compensated employee would have taxable income to the extent that the employee receives over $1,995 in health coverage."

It is unclear from this Example how the benefits test operates under the bill. If the smallest employer-provided benefit is used, why isn't $500 (instead of $1,500) used to measure the taxable benefit in the example? Is it relevant in the example

that each core plan is available to over 90 percent of the nonhighly compensated employees?

Hypothetical Example: Assume an employer has two plants in different geographic locations, and 50 percent of its employees work at each location. Assume further that the employer offers core plan A with an employer cost of $500 to all employees at location A and core plan B with an employer cost of $1,000 to all employees at location B. Finally, assume that a disproportionately larger percent of highly compensated employees work at location A.

Under this hypothetical example, will the highly compensated employees at location B, who receive an employer provided benefit of $1,000 have $200 of taxable income ($1,000 less $800 [1.33 x $600])? Does this result occur because neither plan, by itself, covers 90 percent of the employees?

This would be an absurd result, and surely cannot be intended. In the example each plan is available to all employees at its geographic location on a completely nondiscriminatory basis. Accordingly, the highly compensated employees should have no taxable income.

We believe this potentially fatal defect in H.R. 1864 can be corrected with some minor changes.

Recommended Statutory Language: Proposed Section 89(2)(2)(A)

"(2) TAXABLE BENEFIT UNDER PLANS MEETING ELIGIBILITY REQUIREMENTS.—

(A) IN GENERAL.—The taxable benefit of any highly compensated employee under health plans meeting the requirements of subsection (c) is the excess (if any) of—

(i) *the sum of* such employee's aggregate employer-provided benefit under such *each* plan[s], over

(ii) 133 percent of *the sum of* the amounts which would have been such employee's employer-provided benefit *under each such plan in which he participated* if he had been a participant with the same status in the plan which was taken into account in determining whether the requirements of subsection (c)(1)(B) are met and which would result in the smallest employer-provided benefit determined for purposes of this clause *for each such plan.*" (New language is italic, and language to be deleted is in brackets.)

An additional technical problem exists in applying the benefits test. Proposed Section 89(b)(2)(C) allows an employer to elect to aggregate two or more qualified core health plans and treat them as one plan if each of such plans is available to the same group of employees with the same eligibility requirements.

First, it is not clear whether there must be a 100 percent overlap in the eligible group of employees and in all of the eligibility requirements. For example, if an employer offers an indemnity plan and an HMO, can these plans be aggregated if they have minor differences in employees who are excluded or in waiting periods to commence participation?

A "plan" is not defined in H.R. 1864. It may be necessary to define this term in order to apply-proposed Section 89(b)(2)(C) relating to aggregation of "plans."

4. EXCLUDED EMPLOYEES

(A) Technical Comments

Proposed Section 89(d)(1) would exclude from consideration certain categories of employees, such as employees who have not completed six months of service or who normally work less than 25 hours per week. However, under proposed Section 89(d)(2) these exclusions would not apply unless no employee within the excluded category was eligible to participate in the plan. Further, under proposed Section 89(d)(3) an exclusion for cost categories of excluded employees under Section 89(d)(1) will only be available if the exclusion applies to all health plans of the employer.

As presently drafted, proposed Sections 89(d)(2) and 89(d)(3) will be counterproductive. They will make it difficult for an employer to offer coverage to some employees, including nonhighly compensated employees, within a particular category without offering coverage to all employees within that category. For example, an employer would be required to have the same waiting periods and age limitations for all of its plans. Where this is not presently the case, it will encourage an employer to cut back coverage under all of its plans to the lowest common denominator.

A better solution would be to tax any highly compensated employee who has coverage within any excluded category on the full amount of such employee's employer-provided benefit. To accomplish this, Section 89(d)(2) would be revised, and Section 89(d)(3) would be deleted.

Recommended Statutory Language: Proposed Section 89(d)(2)

"(2) Certain Exclusions Not To Apply If Excluded Employees Covered.—Except to the extent provided in regulations, employees shall not be excluded from consideration under any subparagraph of paragraph (1) (other than subparagraph (E)) unless *either (A)* no employee described in such subparagraph (determined with regard to the last sentence of paragraph (1)) is eligible under the plan *or (B) all highly compensated employees described in such subparagraph who are covered under the plan are treated by the employer as receiving a taxable benefit in the mount of the employee's employer-provided benefit under such plan.*" (New language is italic.)

Section 89(d)(3) would be deleted.

(B) Part-Time Employees

Under H.R. 1864, employees who normally work less than 25 hours per week are disregarded for purposes of the nondiscrimination tests (compared with 17.5 hours under present law). In addition, the employee premium and the employer-provided coverage are proportionately adjusted for less than full-time employees.

Policy Comment

We agree with this exclusion of part-time employees, but think the test should be 30 (rather than 25) hours per week.

(C) Students

Proposed Section 89(d)(1)(F) provides an exclusion for students who are employees of a school, college or university where they are enrolled and regularly attending classes, if core health coverage is made available to such students by their employer.

Policy Comment

We are concerned that the requirement of core health coverage under this provision may make it more difficult for students to obtain employment at schools, colleges and universities. For example, faculty members may be deterred from hiring students as research assistants. We recommend excluding students from being considered as employees of schools, colleges and universities without any requirement that core health coverage be made available to such students.

Technical Comment

If the exclusion for students will retain the requirement that core health coverage be made available to such students, two issues need to be clarified further. First, must the core health coverage for students be the same as for other employees? Second, may the core health coverage be made available at full cost to students, or only within the limits on employee costs contained in proposed Section 89(c)(2)(B)?

A drafting error also needs to be corrected. As presently written, the exclusion for students requires that core health coverage be made available to students. However, under Section 89(d) (2) the exclusion for students would only be available under a plan if no student was available for coverage under the plan. This drafting error could be corrected by revising the language in Section 89(d) (2) which presently reads (other than under subparagraph (E))" to read "(other than under subparagraph (E) or (F))."

5. SPECIAL RULES

(A) Salary Reduction

We are concerned about the potential impact of Section 89 on cafeteria plans and flexible spending accounts. These plans, which are subject to strict regulations under the Internal Revenue Code, are extremely desirable in allowing employees maximum flexibility to select among fringe benefits offered by their employers. For example, many plans allow employees to select among health plans which offer different levels or types of coverage.

H.R. 1864 will have an extremely adverse impact on these plans due to its "Heads I Win, Tails You Lose" treatment of salary reduction contributions. Under the bill, amounts paid through salary reduction are treated as an employee contribution for nonhighly compensated employees, because salary reduction represents a cost to the employee. However, for purposes of determining the employer premium received by highly compensated employees under the benefits test, the bill treats salary reductions as employer contributions.

Unless Congress wants to kill cafeteria plans and flexible spending accounts for *all* employees through the back door of Section 89, it is essential to treat salary reductions in a consistent manner for nonhighly compensated and highly compensated employees. Presumably, salary reductions should be treated as employee costs in

both cases. If salary reductions were treated as employer contributions in both cases, it would undermine the maximum limits on employee costs under the eligibility test.

We do not understand the suggestion in the Floor Statement of Chairman Rostenkowski that if all salary reductions are considered as employee contributions to a plan, the employer could evade the benefits test by providing all or a substantial amount of health coverage to highly compensated employees through salary reduction. Section 125 of the Code currently provides adequate safeguards against excessive benefits for highly compensated employees under cafeteria plans. Section 125(b)(1) prohibits discrimination as to eligibility to participate, and Section 125(b)(2) provides a concentration test under which a plan will fail to qualify if the qualified benefits provided to key employees under the plan exceed 25 percent of the aggregate of such benefits provided for all employees under the plan.

Recommended Statutory Language: Proposed Section 89(e)(3)(C)

"(C) Salary Reduction.—Any contribution by reason of a salary reduction arrangement—

(i) shall be treated as an employee contribution for purposes of determining a highly compensated employee's employer-provided benefit, and

(ii) shall be treated as an employee contribution for purposes of subsections (b)(2)(A)(ii) and (c)." (New language is italic.)

We recommend that Section 125(b) (2) be amended to apply to highly compensated employees, rather than key employees. A conforming amendment to Section 125(b) (3) is also required.

Recommended Statutory Language: Proposed Amendment to Section 125(b) (2) and (3)

"(2) *HIGHLY COMPENSATED EMPLOYEES* [KEY EMPLOYEES]—In the case of a *highly compensated* [key] employee within the meaning of section *414(q)* [416(i)(1)], subsection (a) shall not apply to any plan year if the qualified benefits provided to *highly compensated* [key] employees under the plan exceed 25 percent of the aggregate of such benefits provided for all employees under the plan. For purposes of the preceding sentence, qualified benefits shall not include benefits which (without regard to this paragraph) are includable in gross income.

(3) EXCLUDABLE EMPLOYEES—For purposes of this subsection, there may be excluded from consideration employees who may be excluded from consideration under section *89(d)[(h)]." (New language is italic, and language to be deleted is in brackets.)*

(B) Multiemployer Plans

Proposed Section 89(e)(3)(D)(ii) contains an adjustment provision to the special rule for multiemployer plans. It is unclear how this provision is intended to operate. Proposed Section 89(e)(3)(D)(iii) contains an exception for professionals to the special rule. We strongly oppose this special exception for the reasons discussed below under "Union Employees" and do not believe there is any justification for it. We expect most multiemployer plans to oppose H.R. 1864 unless this special exception is eliminated.

(C) Union Employees

H.R. 1864 provides that plans maintained pursuant to collective bargaining agreements are tested separately with respect to employees in each collective bargaining unit. We assume that proposed Section 89(e)(8) will operate in a manner similar to Section 410(b)(3), which applies to pension plans.

Policy Comments

We agree that union employees should be tested separately under Section 89.

However, under H.R. 1864 the separate testing for union employees would not apply if more than a de minimis number of employees in the collective bargaining unit perform services in the field of health, law, engineering, architecture, accounting, actuarial science, financial services, or consulting or in such other fields as the Secretary may prescribe. We do not believe there is any justification for this exception and strongly oppose it.

There is no evidence of abuse relating to health plans under collective bargaining agreements. Therefore, there is no reason for Congress to treat collective bargaining for health plans differently from pension plans, which are governed by Section 410(b)(3) and have no carve-out for categories of professional employees.

It is common for more than a de minimis number of professional employees to participate in plans established pursuant to collective bargaining agreements, espe-

cially multiemployer plans. Often employees of the labor unions and trust funds are participants in such plans. A number of such employees are professionals, such as attorneys, accountants, actuaries, financial officers and the like. There is no worthwhile policy reason for requiring plans to exclude these individuals from participating in plans (which is a likely result of the proposed exception for professional employees) in order to avoid counting all collective bargaining employees in applying the eligibility tests.

In sum, there is no reason for treating plans established pursuant to collective bargaining agreements differently simply because professionals participate in the plans on exactly the same basis as rank and file employees. The plans which presently cover such employees do not have the abuses of coverage which Section 89 is intended to correct.

As far as we know, the special carve-out for categories of professional employees is new and would be introduced here for the first time. It will interfere very seriously with collective bargaining in the enumerated fields. Many large employers, such as hospitals, will be adversely affected. This proposed new twist is ill-considered, hasty and an unwarranted intrusion by Congress into the collective bargaining arena. Such a provision might make sense, for example, if it applied only where a very large percent (such as 80 percent) of the employees in a collective bargaining unit were highly compensated employees.

There may, also, be jurisdictional issues. The Labor Committees of the House and Senate may need to be consulted before such a major change is made in the treatment of plans established pursuant to collective bargaining agreements.

Technical Comment

Some clarification is needed to indicate how the section would be applied separately to union employees in each collective bargaining unit. We assume proposed Section 89(e)(8) will operate in a manner similar to Section 410(b)(3), which applies to pension plans.

(D) Former Employees

As under present law, the nondiscrimination tests are applied separately to former employees of the employer.

Technical Comments

We agree that the nondiscrimination tests should apply separately to former employees. However, as presently drafted, the bill will discourage employers from offering coverage to any former employees, since it will presumably be necessary to offer coverage to 90 percent of all former employees to satisfy the eligibility test. The bill should be revised to permit coverage to be offered on a non-discriminatory basis to reasonable categories of former employees, such as retirees (rather than all terminated employees) or retirees who retired between or after certain dates. This matter should be clarified in the statute, rather than simply in the legislative history. See *General Explanation of the Tax Reform Act of 1986*, p. 809.

Also, if dollar limits (rather than percentage limits) are retained on employee costs, these dollar limits should be dropped or increased substantially for former employees, due to the far greater costs of medical care for older and retired persons. In particular, medical costs will be greater for former employees who retire early before they are eligible for Medicare benefits.

Recommended Statutory Language: Proposed Section 89(e)(9)

"(9) Treatment Of Former Employees.—Except to the extent provided in regulations, this section shall be applied separately to former employees *(or any reasonable class of former employees which does not (by its terms or otherwise) discriminate in favor of former highly compensated employees)* under requirements similar to the requirements that apply to employees, *except that no dollar limits on employee costs shall apply.*" (New language is italic.)

(E) Leased Employees

H.R. 1864 creates a safe-harbor that allows an employer to disregard leased employees if certain requirements are met. The proposed rule is similar to the leased employee rules applicable to qualified pension plans. Under the bill, an employer may disregard a leased employee if the leasing company certifies that such employee has available a core health plan meeting the limit on mandatory employee contributions of the eligibility test. This rule, like the rule in the pension plan area, is only available if leased employees do not constitute more than 20 percent of the employer's nonhighly compensated workforce.

Policy Comment

A very major difficulty with existing Section 89 is the data-gathering and administrative burden posed with respect to leased employees, particularly for large employers. A corporation's Human Resources Department normally maintains data on employees. However, it frequently lacks information on leased employees which are paid for by the Purchasing Department.

Under Section 410(b)(1)(A) a pension plan can qualify if it benefits at least 70 percent of the nonhighly compensated employees. Accordingly, employers do not need to obtain data on leased employees unless leased employees may approach 30 percent of the employees. Under proposed Section 89 an employer will need to be concerned if leased employees may approach 10 percent of the employees. Given the difficulties in enacting Section 89 and the absence of any perceived abuse, there is no reason to make compliance with respect to leased employees more difficult for health plans than pension plans. We recommend a modification of the eligibility test, which would apply only to leased employees, to make it more analogous to the participation test for pension plans.

Recommended Statutory Language: Proposed Section 89(c)(1)(B)

"(B) the employer maintains 1 or more qualified core health plans and at least 90 percent of all employees *(excluding leased employees) and 70 percent of all employees (including leased employees)* who are not highly compensated employees are eligible to participate in any of such plans." (New language is italic.)

6. FAILURE TO COMPLY WITH QUALIFICATION RULES

An employer's fringe benefit plans are required to meet certain minimum standards, for example, that the plan be in writing, that employees be notified of plan provisions, and that the plan be maintained for the exclusive benefit of employees. Under present law, if an employer's plan does not satisfy these requirements, then all employees must include in income the value of benefits (e.g., reimbursements for health care) received under the plan. H.R. 1864 replaces the present sanction with an excise tax on the employer. The amount of the excise tax would be 34 percent of the amounts paid or incurred during any taxable year under any plan which fails to meet the qualification rules.

Policy Comment

The qualification rules are similar to the requirements for a summary plan description for qualified pension plans. The penalties should be the same as for a failure to provide a summary plan description for pension plans.

The amount of the excise tax proposed in H.R. 1864 is far too high. For a large employer, it could be an extremely large amount of money for a minor and even technical violation. If it is determined to impose an excise tax of the type presently contemplated in H.R. 1864, the amount should be much smaller, perhaps 5% or a specified dollar amount.

7. GROUP TERM LIFE INSURANCE

Under present law, group term life insurance plans are subject to the Section 89 rules. To further simplify Section 89, H.R. 1864 generally provides that the nondiscrimination rules in effect prior to the Tax Reform Act apply to group term life insurance.

Policy Comment

We endorse this provision.

8. EFFECTIVE DATE

We recommend a one year delay in the effective date of Section 89 in order to allow employers sufficient time to comply with the new requirements and provisions of H.R. 1864.

STATEMENT OF THE MASSACHUSETTS MUTUAL LIFE INSURANCE COMPANY

(Submitted by Thomas B. Wheeler, President and Chief Executive Officer)

I am Thomas B. Wheeler, President and Chief Executive Officer of Massachusetts Mutual Life Insurance Company. I appreciate the opportunity to present this testimony to the Committee.

Mass Mutual, organized in 1851, is the 11th largest insurance company in the United States. It sells individual policies of life insurance and annuities and group life and health insurance. Its policyholders are in all 50 states and the District of Columbia.

As a group health insurer, Mass Mutual does business with employers that range in size from fifteen employees to five thousand employees. We have learned first-hand how the complexities of Section 89 have confused employers of every size and type of business. We have also observed how the provisions of Section 89 have discouraged the introduction of cost containment programs, improvements in coverage, supplemental insurance plans and the expansion of coverage. Instead of working on innovations in group health programs, employers have been obsessed with finding ways to reduce the number of "Section 89" plans that must be tested.

Therefore, I would like to commend Chairman Bentsen for his leadership and Senator Pryor the other cosponsors for their introduction of S. 654. I would also like to commend other members of Congress who have expressed their concern regarding the problems of employers who have been struggling to comply with the requirements of present law.

Although Mass Mutual supports the simplified testing approach embodied in the bill, we believe that many employers will have problems complying with some of the requirements of this simplified test. It would be unfair to penalize employers who have done everything possible to provide coverage to a broadbase of employees. Thus, we recommend several changes to H.R. 1864.

FIFTY PERCENT LIMIT ON PREMIUM CONTRIBUTION RATHER THAN DOLLAR LIMITS

Currently, S. 654 would cap the premium to be paid by a non- highly compensated employee to $6.70 per week for individual coverage and $13.40 per week for family coverage. These amounts would be indexed and tied to increases in the minimum wage. The problem is that the medical inflation rate historically has risen at a greater rate than most other economic indicators and cost of living adjustments. At the present time, the dollar limits may be high enough for many plans to pass, but they will not remain so even though the caps are indexed.

The IRS and some members of Congress may believe that employers, especially small employers, may be tempted to establish high premium contribution levels in order to discourage participation by non-highly compensated employees. A 1988 report on health insurance and the uninsured published by the Congressional Research Service contains statistical facts which suggest otherwise. Employee contributions are generally determined by the amount of money employers have available to pay for health coverage. See *Health Insurance and the Uninsured: Background Data and Analysis*, June 9, 1988, pp. 102-110.

The report states that the average total monthly premium in 1987 was $77 for individual coverage and $201 for family coverage. Forty-two percent of the individual rates were between $60 and $79 a month. Forty-four percent of the family coverage rates were between $160 and $219 a month.

The study also states that premiums for any particular plan can be significantly higher or lower than the premiums for another plan with identical benefits because of factors unique to the employer.

One important factor is location. Differences also arise from the demographics of the group. If an employer has a work force which is younger than average, it will probably have lower costs than average.

Premiums will also fluctuate with the claim experience of the group for larger employers. The true long-term cost of a plan is the premium needed to cover the claims and administrative costs, less investment income earned on premiums. If the claim and administrative expenses are greater than premium income in a given year, the insurer may recover deficits through future rate increases. Conversely, excess reserves from favorable experience will be used to reduce future premium costs.

The study found that employers typically require less than one-fourth of the cost be paid by the employee. Only three percent required a contribution of more than thirty-five percent of total cost. About a third of employees pay the total premium for dependents. Plans that require the employee to pay a share of the additional dependent cost typically require payment of a fourth of the cost. Four percent of plans require employees to pay the entire cost of dependent coverage.

Sixty-one percent of large employers and seventy percent of small employers pay the full cost of the health plan for individual coverage, the report said. Only twenty-five percent of large employers pay the full cost of family coverage, compared to sixty percent of small employers and seventy percent of small employers who have fewer than ten employees.

Small employers are more likely to pay the full cost of the health care plan because of insurance company requirements which seek to ensure that most healthy employees participate in the plan to balance the cost of higher-risk employees. Insurers do not have the same requirements for large employers because non- participation of a few employees will not significantly affect the cost.

From 1982 to 1987, the average employee premium had risen thirty-five percent. As total premiums have risen, employees have had to pay a larger share because employers do not have unlimited dollars to spend on health coverage. In 1977 through 1983, two-thirds of employers paid the full cost of employee coverage and forty percent of the full cost of dependent coverage. By 1987, however, employers were paying the full cost for substantially fewer employees.

As medical costs continue to rise, employers, with only limited dollars to spend on health care, will ask employees to contribute more to their health coverage. If the rate of medical inflation could be brought under control, employers would be able to finance their plans with smaller contributions from their employees. Many believe, however, that it is not unreasonable to ask employees to contribute as much as fifty percent of the premium. Even with that level of contribution, group coverage would be a better "deal" for employees than an individual policy of health insurance. Individual policies are underwritten on an individual basis. Persons who have had serious illnesses may never obtain coverage or may be issued an expensive policy that contains riders which exempt certain illnesses from coverage.

Allowing employers to base premium contributions on a percentage of premiums dispenses with the need to index caps. It also gives employers enormous flexibility in financing their plans during periods of abnormal claim experience.

DEFINITION OF PART-TIME EMPLOYEES AND INDEPENDENT CONTRACTORS

Part-time employees should be defined as those working less than thirty hours per week. This is consistent with the eligibility requirements of many group insurance policies. If employers have to cover persons who work less than thirty hours, it will be difficult for many employers to obtain coverage for their employees.

Independent contractors should not be treated as leased employees or as persons eligible for participation in a plan for common law employees. In many cases, independent contractors (e.g., full-time life insurance agents) do not participate in the same plan with common law employees. The differences in coverage often reflect differences in the nature of the economic relationship with the sponsoring employer. Independent contractors are not so easily defined as highly and non-highly compensated employees, since the amount of their income is generally within their control and is not determined by the employer. Whether they have coverage is not determined by whether they are highly or non-highly compensated employees. Therefore, the social purposes of Section 89 would not be furthered by comparing their plans with the plan for common law employees.

CONCLUSION

We appreciate your consideration of our views. If we can assist you and your staff, please do not hesitate to call upon us.

STATEMENT OF THE MOTION PICTURE ASSOCIATION OF AMERICA, INC.

(Submitted by William P. McClure and William D. Hawkins III)

On behalf of the Motion Picture Association of America, Inc., the following statement is presented for inclusion in the record of the hearings on section 89 of the Internal Revenue Code. Section 89 of the Internal Revenue Code of 1986, as amended, requires that employer-provided health insurance plans and group-term life insurance plans satisfy various nondiscrimination tests. As discussed below, we believe the administrative difficulties in applying the nondiscrimination tests under section 89 impose unwarranted burdens on the motion picture industry that should be corrected. While both H.R. 1864 and S. 654 represent a significant improvement over present law, neither of these bills adequately addresses the unwarranted burdens placed on the motion picture industry.

The motion picture industry consists predominantly of companies engaged in the production and distribution of theatrical films and television movies and programs. The vast majority of employees engaged in the production of these films and television shows are union and guild employees who do not work for a single company, but work for any of the motion picture companies engaged in production. For exam-

ple, Paramount Pictures Corporation ("Paramount") has a nonunion, full-time staff of approximately 2,000 employees, but employs approximately 21,000 union and guild employees annually in the production of theatrical films and television movies and programs.

The union and guild employees (hereinafter collectively referred to as "union employees") involved in production include, among others, writers, directors, actors, musicians, sound technicians, camera operators, lighting technicians, costume designers, and set designers. The vast majority of these employees work for a company on a daily or weekly basis, and are informed at the end of the day or week, respectively, whether their services will be necessary for the following day or week. The companies maintain sufficient payroll information to pay these employees and issue W-2 information.

All of these employees are covered by jointly-administered Taft-Hartley health plans (hereinafter referred to as "multiemployer plans"). Pursuant to collectively bargained industry-wide agreements, the companies employing these workers make contributions to the multiemployer plans. Four multiemployer plans cover virtually all of these union employees. For the vast majority of these employees, a company contributes $1.295 per hour for each hour worked or guaranteed by the company. This contribution is made to a multiemployer health plan, the "Motion Picture Health and Welfare Fund," (the "MPHWF") which covers virtually all the union employees other than writers, actors, and directors. These contributions are not affected by whether family or single coverage is involved or the amount of the employee's compensation. The other three primary plans generally provide for a set percentage of compensation (at least six percent) to be contributed to the plan.

Under the MPHWF, covered employees receive extensive health benefits provided either by an HMO or Blue Cross of California in conjunction with the MPHWF (and thus, the MPHWF is partially self-insured). In addition, prescription, dental, and vision benefits are provided. Similar benefits are provided by the other three primary multiemployer health plans. The benefits provided by these multiemployer health plans are extensive. We have been informed by officials of the motion picture industry that the health benefits provided under these multiemployer plans are comparable in quality (and in some cases, of better quality) than the health plans covering the companies' own nonunion employees.

These multiemployer health plans create three primary problems under section 89 for the motion picture industry: (1) determining the value of benefits; (2) determining who is a highly-compensated employee; and (3) recordkeeping.

1. DETERMINING THE VALUE OF BENEFITS

The application of section 89 to the multiemployer plans covering the motion picture industry creates significant problems in performing the nondiscrimination tests required by section 89. Many of the plans maintained by the companies that cover their nonunion employees will not be able to satisfy either the 50-percent eligibility test (section 89(d) (1)(B) or (d)(2)) or the 80-percent coverage test (section 89(f)) without being tested together with the multiemployer plans. In order to be tested together, the companies' own plans and the multiemployer plans must be found "comparable" within the meaning of section 89(g)(1). For purposes of determining comparability under the 50-percent eligibility test, the companies' own plans and the multiemployer plans must be found to have employer-provided benefits within 95 percent of each other. A finding of comparability under the 80-percent coverage test requires that the value of employer-provided benefits be within 90 percent of each other (or 80 percent if the plan covers 90 percent of the nonhighly compensated employees). While these comparability tests may be relatively simple to administer when the plans involve insurance premiums paid to a third-party provider, the tests become extremely complex when multiemployer plans that are self-insured are involved.

The Technical and Miscellaneous Revenue Act of 1988 ("TAMRA") attempted to ease the difficulty of determining the value of the employer-provided benefit of a multiemployer plan (until regulations dealing with valuation are issued) by providing that the employer could use contributions to the multiemployer plan on behalf of the employee as the value of that employee's employer-provided benefit. The committee reports to TAMRA provide for adjustments to this computed value if the benefits actually received are at variance to contribution rates (*e.g.*, if the same amount is contributed on behalf of each employee whether or not family coverage is received).

Under the MPHWF, employers contribute on the basis of a set dollar amount per hour worked or guaranteed. An employee is covered by the plan for a six-month period if he or she worked or was guaranteed a minimum of 300 hours in a prior six-month testing period (*e.g.*, if an employee works 300 hours for participating em-

ployers between April 1 and September 30, that employee is entitled to coverage under the plan from January 1 through June 30 of the following year). The 300-hour minimum is based on the aggregate hours worked or guaranteed for all the 225 signatory producer parties participating in the plan. The contributions to the plan are the same whether the employee has single coverage or family coverage.

These facts create extraordinary difficulties in determining the value of the employer-provided benefit under this plan. First, no distinction is made in contributions between single and family coverage. Second, because of the mobility of these employees within the industry, an employee might work only one day (ten hours) for Paramount, and work 290 hours with other motion picture companies during the six-month testing period. Thus, that employee would be entitled to full coverage under the plan for six months, but Paramount would have only contributed $12.95 on behalf of that employee. It clearly would not make any sense to treat that employee as having an employer-provided benefit valued at $12.95 for purposes of testing Paramount's plans.

Another problem is the fact that contributions to collectively bargained plans are set when the parties enter into the collective bargaining agreement. In the case of the collective bargaining agreements covering motion picture industry employees, the term of many of these agreements is three years. This fact can result in significant disparity between the value for purposes of section 89 of the employer-provided benefit of a normal health insurance plan, under which the premiums change on a yearly basis, and the value for purposes of section 89 of the employer-provided benefit of a multiemployer plan where the contributions are set for a three-year period. This disparity is particularly acute in times such as these where many employers are experiencing 40-percent annual increases in health insurance premiums. Thus, while contributions to the MPHWF have remained constant for the last three years, the insurance premiums for Paramount's own health plans have increased an average of 30 percent during the same period. No provision exists in the statute, proposed regulations, or committee reports for allowing an adjustment to compensate for this type of significant increase in health care costs during the term of the collective bargaining agreement.

All of these factors dictate that adjustments be made in order to calculate the value of the employer-provided benefit for purposes of a comparability analysis. The problem is that no guidelines exist for making such adjustments and any such adjustments would be imprecise at best. To then require 95-percent comparability with the companies' own plans or other multiemployer plans to which the company contributes for purposes of the 50-percent eligibility test (90 percent for the 80-percent coverage test) creates a situation where the companies can never have any comfort in the fact that they are complying with section 89. These difficulties in using contributions to measure value show that, at least in the case of the motion picture industry multiemployer health plans, employer contributions to the plans do not provide a workable measure of the value of the employer-provided benefit for purposes of determining comparability.

The inability to accurately measure the value of the employer-provided benefit for these multiemployer plans also has a negative impact on the ability to perform (and possibly satisfy) the 90-percent/50-percent eligibility test (section 89(d)(1)(A)) and the 75-percent average benefits test (section 89(e)), which tests must be satisfied if the 50-percent eligibility test is used. As previously discussed, the mobility of employees within the motion picture industry results in the possibility of employees having absurdly low contributions made on their behalf by a single company, yet the employee receives coverage under a generous health plan. In addition, the fact that contributions are set for the term of the collective bargaining agreement results in the value of the employer-provided benefit remaining constant during the term while the value of benefits under a traditional health insurance plan increases annually. Even if adjustments are made to compensate for these factors, a serious question exists as to whether the 90-percent/50-percent eligibility test and the 75-percent average benefits test can be satisfied. Again, these problems reinforce the conclusion that employer contributions are an inadequate measure of value for these plans.

2. DETERMINING WHO IS A HIGHLY-COMPENSATED EMPLOYEE

The classification of the union employees as highly-compensated or nonhighly-compensated employees creates additional difficulties in complying with section 89. These difficulties are created by the fact that the motion picture industry union employees, on average, work for several employers in the industry during a single year. Thus, an employee that would be a highly-compensated employee if all of his or her compensation from the motion picture industry companies were combined, generally would not satisfy the test for highly-compensated employees vis-a-vis each

separate company. The Code and regulations generally test highly-compensated employee status on an employer-by-employer basis unless the employers are affiliated in certain ways. Because the test is performed on an employer-by-employer basis, an inaccurate picture of which employees are highly compensated and which are non-highly compensated will emerge.

3. RECORDKEEPING

In addition to these testing problems, section 89 imposes onerous recordkeeping requirements on the motion picture industry companies. As previously discussed, these employees usually work for several of the companies engaged in the motion picture industry throughout the year. Only records relating to compensation currently are maintained by the companies for these employees. Section 89 compliance will require the maintenance by the individual companies of detailed records for each employee relating to periods of employment with the employer, compensation, and hours worked or guaranteed (for plan eligibility purposes and for determining the value of the employer-provided benefit).

Further recordkeeping will be required to compute the value of the employer-provided benefit. Information such as the family status of each union employee (in order to make a proper adjustment to contributions to the multiemployer plan to value employee-only and family-only coverage) will have to be maintained for each employee. In addition, the employee's total compensation will have to be obtained and maintained in order to properly test highly-compensated employee status. As with the testing problems, many of the recordkeeping problems arise from the fact that these employees do not normally work for a single employer during the year.

As the previous discussion has shown, these union employees receive generous health benefits under the various multiemployer plans. Nevertheless, the motion picture industry is now required by section 89 to expend significant resources to generate the information necessary to prove that these plans, together with the companies' own plans, satisfy section 89. Moreover, the industry faces the distinct possibility that section 89 will not be satisfied even though all of these plans provide substantially equivalent benefits. We strongly believe that union employees in the motion picture industry should be excluded from the application of section 89.

There are two primary reasons for excluding union employees. First, the logic of excluding from the application of section 89 union employees for whom no health benefits are provided by the employer, while including union employees who receive health benefits contributed by the employer, is a mystery to us. Instead of encouraging employers to cover more employees with health insurance (a professed premise for the enactment of section 89), this provision encourages employers to *eliminate* health benefits from a collective bargaining agreement and instead, to pay additional compensation in a form other than health benefits. This result obviously is contrary to the intent of Congress.

Second, the exclusion of union employees finds its basis in the pension provisions. All of the nondiscrimination provisions dealing with pensions (sections 401(a)(4) 410(b) and 401(a)(26)) exclude union employees. The rationale for this exclusion was first set forth in the Employee Retirement Income Security Act of 1974 ("ERISA") where the Senate Finance Committee Report stated:

> The committee believes that this situation [*i.e.*, the inclusion of union employees in discrimination testing] can result in a hardship, where all employees of an employer are forced to forego the benefits of a pension plan merely because those employees who are covered under a collective bargaining agreement choose nonpension benefits, or nonpension benefits plus pension benefits at a lower level than those provided nonunion employees.

S. Rept. No. 93-383, 93rd Cong., 1st Sess. 42 (August 21, 1973). In order to protect against any abuse from this exclusion, the Secretary of the Treasury was given the authority to allow the exclusion only where there is evidence that the benefits were the subject of good faith bargaining between the employer and the employee representatives.

This same rationale is equally applicable to section 89. Where health benefits are part of good faith bargaining between an employer and the employee representatives, the employer's nonunion employees should not be penalized because the employee representatives bargain for a compensation package that may or may not include health coverage on a par with the employer's own plans. Section 89 may force employers to either eliminate health benefits in the collective bargaining agreement (and thus qualify for the exclusion of union employees) or force the union employees to agree to lower cash compensation in order to provide health benefits comparable to the employer's own plans. We believe that the good faith standard is sufficient to

protect the union employees under section 89 in the same way it protects such employees under the pension nondiscrimination provisions.

In the alternative, a provision could be drafted to exclude union employees covered by multiemployer plans benefiting workers in the motion picture industry. The provision could be drafted as an exception to the application of section 89(h)(3)(A) for employees described in section 89(h)(1)(E) who normally work during the year for more than one employer participating in the collective bargaining agreement. This provision would then eliminate the burdens of section 89 for testing those employees in the motion picture industry who normally work for more than one company, since it is these employees who create the greatest difficulties for the industry in performing the nondiscrimination tests of section 89.

H.R. 1864

H.R. 1864 replaces the current nondiscrimination tests of section 89 with a new 90-percent eligibility test. Because the four primary multiemployer health plans associated with the motion picture industry do not require employee contributions, the only real issue is whether the 90-percent eligibility test is satisfied. Under the bill, each of the motion picture industry companies will test each of the union plans separately. Thus, for example, Paramount will be required to determine whether 90 percent of its union employees on whose behalf Paramount contributes to the MPHWF are actually eligible to participate in the MPHWF.

The problem facing the industry companies is that the MPHWF has very complex eligibility rules that require information not available to the participating companies. The MPHWF has two eligibility rules: an initial eligibility rule and a continuing eligibility rule. For purposes of both of these rules, there are eligibility periods (*i.e.*, six-month periods (approximately January 1 to June 30 and July 1 to December 31) during which a participant is entitled to receive benefits) and qualifying periods (*i.e.*, six-month periods (approximately April 1 to September 30 and October 1 to March 31) during which a minimum number of hours must be worked for all the participating employers in the aggregate in order to receive benefits during the following eligibility period).

In order to initially receive benefits (or to receive benefits after not receiving benefits in the five prior consecutive eligibility periods), a participant will become eligible for benefits either (1) in an eligibility period subsequent to a qualifying period in which the participant worked a minimum of 600 hours, or (2) in an eligibility period subsequent to two consecutive qualifying periods in which the participant worked a minimum of 600 hours. For example, if Participant A worked a total of 600 hours for participating employers during the period from April 1 to September 30, 1989, Participant A would be entitled to receive benefits the following January 1 to June 30, 1990.

After satisfying the initial eligibility requirements, a participant will continue to receive benefits for each eligibility period so long as the participant worked 300 hours during the previous qualifying period. For example, Participant A will continue to receive benefits from July 1 to December 31, 1990, so long as Participant A works a minimum of 300 hours for participating employers during the previous October 1, 1989 to March 31, 1990.

Thus, under the MPHWF, a participant's eligibility must be redetermined every six months. Obviously, each participating employer will not have the information necessary to determine whether the participant is eligible under the plan on any given date except in those rare situations where the participant worked a sufficient number of hours for that employer during the previous qualifying period. The information necessary to determine each participant's eligibility to participate is available other than in rare circumstances only to the plan administrators. Therefore, the 225 participating employers will each have to obtain from the plan administrators of the MPHWF information relating to the eligibility of the approximately 20,000 union members in order to perform the 90-percent eligibility test.

Besides being administratively difficult, this places a burden on the employer to obtain information from the multiemployer plan administrators in order to perform the 90-percent eligibility test. We believe it is unfair and oftentimes unrealistic to require employers to obtain information from the multiemployer plans in order to conduct the nondiscrimination test. This difficulty was recognized in TAMRA where several concessions were made to employers participating in multiemployer plans to reduce the amount of information needed from the multiemployer plan administrators to perform the tests required by section 89.

We believe multiemployer health plans should not be subject to the nondiscrimination test of H.R. 1864. Under H.R. 1864, multiemployer plans are allowed to be tested separately. We do not believe there is any evidence to suggest that multiem-

ployer health plans discriminate between their highly-compensated employees and their nonhighly-compensated employees. Because the purpose behind section 89 is to prevent discrimination in health plans, no purpose is served by requiring multiemployer health plans to be tested for nondiscrimination since there is no evidence to suggest that a discrimination problem exists in multiemployer health plans.

As an alternative, we believe that it would be more appropriate to have the multiemployer plan administrators perform the nondiscrimination test for all the union employees. This approach would place the burden of testing upon the party who has the information necessary to conduct the testing.

If an exemption is not granted for multiemployer health plans and the participating employers are required to test their employees' participation in these plans, we believe a provision should be inserted that would provide that, for purposes of testing multiemployer plans under the 90-percent eligibility test, a participant in the plan is deemed to be eligible under the plan if the testing employer contributed to the plan on behalf of the participant for work performed on the testing date. This provision would allow the employer to perform the nondiscrimination test of section 89 based on facts within its own knowledge, instead of having to rely on obtaining the necessary information from the multiemployer plan administrators. While such a provision would not afford the absolute accuracy of actually determining whether a participant was in fact eligible to participate, such slight inaccuracy easily can be justified by the fact that the employer is actually funding the cost of health benefits. The fact that the multiemployer plan might have unusual eligibility rules that do not allow a participant to participate even though the employer is contributing on behalf of the participant should not prevent the plan from satisfying section 89 vis-a-vis that employer. The employer is satisfying one of the purposes behind section 89 by contributing to the multiemployer plan on behalf of the participant.

In addition to problems with obtaining information necessary to perform the nondiscrimination test, other significant problems exist under H.R. 1864. The ability of a motion picture industry company to satisfy the 90-percent eligibility test of section 89 will depend entirely on its "luck" as to whom it hires on the testing date. If a company is fortunate enough to hire a sufficient number of union employees on the testing date who are eligible to participate in the MPHWF to satisfy the 90-percent eligibility test, that company's highly-compensated employees will not be subject to taxation of their health benefits. However, a less fortunate company might unknowingly hire a sufficient number of union employees on the testing date who are not eligible to participate to fail the 90-percent eligibility test, and thus its highly-compensated employees will have amounts included in income attributable to their health benefits.

This result occurs because of the fact that the union employees do not work for a single employer. Instead, section 89 is testing a company's employee's participation in the multiemployer plan based on the random set of employees who happen to work for the employer on the testing date. Thus, the results of the test are not primarily dependent on plan design, but upon random chance based on the employees hired on the testing date. Such an application of section 89 defeats the purpose of the design-based test of H.R. 1864 and will create unintended results.

An employer who fails section 89 would have to determine which of its employees were highly compensated. Due to the fact that virtually all the employees work for more than one employer in the industry, the number of employees treated as highly compensated for that employer will not present an accurate picture of which employees in the industry are truly highly compensated. For example, a union employee might earn $100,000 per year, but may have only earned $25,000 from the employer who failed the test. Thus, this employee would not be treated as highly compensated vis-a-vis that employer, while another union employee earning $60,000 per year having worked only for the employer failing section 89, will be treated as highly compensated, and will have amounts included in his or her income. This result makes absolutely no sense because the lower-paid employee, who is receiving benefits identical to the higher-paid employee, will have amounts included in income, while such amounts are excluded from the income of the higher-paid employee. Such a result reinforces the fact that the application of section 89 on an employer-by-employer basis to the multiemployer plans covering the motion picture industry employees does not serve any legitimate purpose and is likely to create gross inequities.

In then determining the amount to be included in income, employer contributions do not serve as an adequate measure of value since the test looks only to a single employer's contribution to the plan. Thus, without making adjustments (for which no guidance has been issued) a highly-compensated employee who works the entire year for the employer failing section 89 would have twice as much included in

income as a highly-compensated employee who worked one-half as many hours for that employer, but received the same benefits.

In addition, H.R. 1864 changes the sanction for failure to satisfy the qualification rules from a tax on the employees to a 34-percent excise tax imposed on the employer. While in general this change more properly punishes the offending party, it serves an injustice to employers contributing to multiemployer health plans. Such employers do not administer these plans and have no control over whether the plan satisfies the qualification requirements. We believe that the multiemployer plan administrators are the proper party to be penalized for any failure to satisfy the qualification rules because they control whether or not these rules are satisfied.

S. 654

S. 654 creates a safe harbor to the nondiscrimination tests of section 89 for "simplified health arrangements." As with H.R. 1864, the safe harbor test primarily focuses on eligibility to participate. As discussed in connection with H.R. 1864, the motion picture industry companies do not possess the information necessary to determine whether their union employees are eligible to participate. The changes recommended to the eligibility test of H.R. 1864 equally apply to S. 654.

STATEMENT OF THE MOTOR VEHICLE MANUFACTURERS ASSOCIATION OF THE UNITED STATES, INC.

The Motor Vehicle Manufacturers Association of the United States, Inc. (MVMA) supports Chairman Lloyd Bentsen and the Senate Finance committee's effort to simplify Section 89, the antidiscrimination rules applicable to certain employee benefit plans. MVHA is a trade association, whose members produce 97 percent of all domestic motor vehicles.

MVMA believes that a bill similar to H.R. 1864 would help simplify the recordkeeping requirements of Section 89 and would help lower the cost of compliance. However, we believe that some of the provisions of H.R. 1864 need further refinement. Specifically, MVMA believes that the provisions related to union employees, salary reduction contributions, leased employees, and former employees need to be reexamined.

UNION EMPLOYEES

Section 89(e)(8)(A) of H.R. 1864 reads, "If an employer has employees included in any qualified bargaining unit, this section shall be applied separately with respect to employees included in each unit." This section disadvantages employers with union employees.

Some proponents of H.R. 1864 have said that separate testing of union employees parallels pension nondiscrimination rules, within which bargained employees are tested separately. However, pension rules, partly in recognition of the effects of separate testing, impose a 70 percent standard. It is misleading, at best, to copy the separate pension testing of union employees without also adjusting the tests accordingly as is done for pensions.

The social objective of Section 89 is to assure a fair balance of benefits between highly and non-highly compensated employees. In the motor vehicle manufacturing industry, the health care benefits of a significant number of non-highly compensated employees are subject to collective bargaining. If these employees are excluded when testing remaining employees, the result may not reflect the true balance of benefits between highly and non-highly compensated employees. *Section 89 test results should not depend on whether rank-and-file employees in an industry are unionized.*

Further, the proposed rule has great potential for disadvantaging some groups of employees versus others working for the same firm. Because bargained and nonbargained employees would be combined for the purposes of identifying highly compensated employees, but separated for testing purposes, it is likely that a greater number of nonbargained employees would be subject to added taxes on benefits than would be the case if the group were combined.

Companies which operate in industries characterized by heavy unionization of rank-and-file employees should be able to elect to take those employees into account in their 90 percent eligibility test under Section 89 without mandatory segregation based on bargained status. This election would be binding and could only be changed with the consent of the Commissioner. This could be done by including lan-

guage in Section (8)(A) that employers may include union employees in their eligibility test.

SALARY REDUCTION CONTRIBUTIONS

As proposed under H.R. 1864, Section 89(e)(3)(C) provides that any contribution by reason of a salary reduction arrangement would be treated as (i) an employer contribution to determine a highly compensated employee's employer-provided benefit, but (ii) an employee contribution for purposes of subsections (b)(2)(A)(ii) and (c).

The bill's proposed 133 percent test identifies the cost of benefits available to 90 percent of the rank and file employees (base benefit). This base benefit is multiplied by 133 percent to determine the maximum nontaxable benefits for highly compensated employees. Under H.R. 1864 salary reduction contributions would not be included in the base benefits when determining the highest nontaxable benefit. However, the actual benefit provided to a highly compensated employee would include such salary reduction contribution to determine the taxable portion in excess of the 133 percent amount.

This treatment of salary reduction contributions, for some companies, is inconsistent and excessively harsh. The result is that non-highly compensated employees may receive greater nontaxable benefits than highly compensated employees even though the 133 percent benefits test would appear to allow a 33 percent disparity in favor of the higher paid.

For purposes of the 133 percent test, we request that you consider the following alternatives, each of which provides a reasonable allowance to highly compensated employees for salary reduction contributions.

1. Distinguish employer-provided cashable credits under Section 125 cafeteria benefit plans from other salary reduction contributions. Allow existing Section 125 nondiscrimination tests to govern the use of cashable credits, and provide uniform treatment of credits for highly and nonhighly paid employees.

2. Codify the position reflected in the Technical and Miscellaneous Revenue Act of 1988 (TAMRA) and Q&A-8(c) of the Proposed Regulations under Section 89 that salary reduction contributions are not required to be treated as employer contributions unless there are no true employer contributions. For example, treat salary reduction contributions as employer contributions where more than 50 percent of the value of the total core benefit attributable to employer contributions is paid from salary reduction contributions.

3. Increase the 133 percent multiplier to 200 percent, which would be consistent with the 90 percent/50 percent eligibility test under existing law.

LEASED EMPLOYEES

H.R. 1864 provides that leased employees do not have to be counted if the leasing company makes available affordable core health coverage. This provision does not adequately address a very serious problem. The problem is that, in most cases, an employer cannot determine who its leased employees are. For example, under current law, it is impossible to determine whether a company's leased employees include the employees of its suppliers, the employees of a construction company that it hires to build a plant, or the employees of a commercial laundry that it uses to launder the uniforms worn by its own employees.

The Treasury's proposed leasing regulations have completely failed to provide the specific definition that employers need. To make matters worse, the regulations also have gone beyond the intent of congress to treat as leased employees many individuals who never were intended to be covered.

MVMA urges that the bill be revised to provide that leased employees will not be taken into account until plan years that begin at least one year after the publication of the final employee leasing regulations.

FORMER EMPLOYEES

The bill delays the rules for former employees for one year. Although MVMA welcomes the one year delay, Section 89 should not apply to former employees at all until congress fashions appropriate rules for them. Unlike current employees, former employees do not have regular contacts with their former employers. As a result, most employers do not have the information that will be required if the availability standards that apply to current employees also are applied to former employees.

In addition, postemployment benefits typically depend on two factors: the type of termination, and the length of service while employed. Few employers would pass the 90 percent test across the entire range of former employees, which can include

voluntary terminations. Drafting appropriate rules is most difficult for retiree health care, for which most companies require a minimum of service to qualify (such as 10 years). This critical issue should not be left to regulations. *We urge that former employees be excluded from testing until a congressional study of the issue has been completed. We also believe that former employees should be included prospectively.*

In addition, MVMA and its member companies have concerns with other provisions in H.R. 1864.

- Accidental death and dismemberment coverage and business travel accident insurance should be excluded from Section 89. We suggest these items should be covered under separate rules, possibly the nondiscrimination rules of Section 79.
- The penalty for failure to comply with the qualification requirements is excessive. There should be both a *de minimis* and good faith exception. A two-tier penalty system would also be appropriate.
- In valuing benefits for testing, when cost-based methods are used, geographic, utilization and demographic disparities should be able to be taken into account on a good faith basis.
- The transition period provided to use old rules should be lengthened.
- The nondiscriminatory provision test should be written as in the present legislative history to apply only to terms which are nonquantifiable.
- In determining taxable income an employer should have the option to elect that the provisions ought to provide true one-day testing; for example, similar to determination of marital status at the end of the year.

MVMA would welcome any questions on these points.

STATEMENT OF THE NATIONAL ASSOCIATION OF COLLEGE AND UNIVERSITY BUSINESS OFFICERS; AMERICAN COUNCIL ON EDUCATION; NATIONAL ASSOCIATION OF INDEPENDENT COLLEGES AND UNIVERSITIES

On behalf of the National Association of College and University Business Officers, an organization that represents over 2100 colleges and universities, the American Council on Education, and the National Association of Independent Colleges and Universities, we strongly urge you to support significant changes to simplify or repeal IRC Section. 89.

Colleges and universities are not largely made of mortar and machinery, but consist of people dedicated to the educational process. In fact, colleges and universities are among the most labor-intensive employers in the nation, expending an enormous percentage of their operating budget on employment related costs. Employer provided benefits have traditionally constituted a large part of college and university compensation packages, both because of the relatively low salaries provided to faculty and staff and because of the attention to comprehensive and innovated fringe benefits. For example, at Purdue University, the total faculty and staff employment numbers 13,244. But a great number of their employees are students attending the University in pursuit of their own educational endeavors. Purdue has, for instance, 777 graduate instructors, 1,367 graduate teaching assistants, 940 graduate research assistants, 169 fellows, and 245 student administrative personnel. In addition, nearly 7,000 undergraduates work in kitchens, offices, and laboratories through work study programs and other student employment efforts intended to, at least in part, offset their educational expenses. Because of the large investment of people in the educational system and the diversity of employees, colleges and universities are very concerned about the negative effect of Section 89.

The Technical and Miscellaneous Revenue Act passed by Congress in late 1988 included an important amendment permitting colleges and universities to exclude from the testing process students working part-time on campus (IRC Section 3121), provided that core health coverage was available. This is an important provision which recognizes the special status of student employment in the education process. The inclusion of students for Section 89 testing purposes would cause most of the nations 3,500 institutions to fail the tests outright. The financial impact of such a possibility would have been enormous.

We support the concept that tax-favored benefits should not discriminate in favor of highly compensated employees. Our problems, concerns and objections to Section 89 extend to other issues which are summarized as follows:

- Section 89 punishes employers whose employees fit within certain employee patterns. It also punishes employers who cannot allocate the resources necessary to understand, gather, analyze, and manipulate the data needed under the Section 89

requirements. Thus, although Section 89 takes aim at discriminatory plans, it affects many employers who are seeking to provide fair and innovative employee programs.

• Section 89 is deceptively easy to describe but difficult to truly understand and apply. It is simple to describe the requirements of Section 89. However, the efforts necessary to understand the hidden. complexities and to comply with them are extraordinary and should not be underestimated because of the superficial simplicity of Section 89.

• Section 89 requires a massive diversion of resources, yet generates questionable results. Section 89 will require colleges and universities to spend significant sums of money and invest substantial amounts of employees' time to collect, maintain and report data on benefit programs that are not designed to be discriminatory. Yet college and university benefit programs designed to currently reflect employer and employee needs will, for the most part, be unchanged because they are not discriminatory.

• Section 89 imposes a narrow and rigid view on "approved" benefit designs and fails to reflect the advantages of employer flexibility and employee choice making.

The following sections further describe our problems and concerns with Section 89 and provide specific examples:

1. SECTION 89 DOES NOT ONLY PUNISH DISCRIMINATION

To say that Section 89 punishes discriminatory benefits is to say that runners who do not finish marathons are lazy. Although Section 89 is designed to punish discriminatory benefits, there are many ways to fail Section 89 that have nothing to do with discrimination. Here are some examples:

• The University of Cincinnati, which currently enrolls 30,830 students, is in a transition process moving employee groups to a cafeteria plan as collective bargaining agreements are renegotiated. During 1989, some employee groups will be covered by the cafeteria plan while others will not. All eligible employees, whether under the cafeteria plan or not, receive employer provided life insurance coverage equal to one times annual salary. The cafeteria plan allows participants to "opt down" to $5,000 in coverage; so for all cafeteria plan participants, the value of employer provided coverage for Section 89 testing purposes is only $5,000. Those outside the cafeteria plan are treated for testing purposes as receiving employer provided coverage equal to one times annual salary. Because of the proportion of highly compensated employees in the latter group, their life insurance plan is likely to fail the test, despite the fact that everyone receives the same employer paid benefit.

• At Purdue University over 80% of highly compensated employees elect family medical coverage, while under 60% of Purdue's nonhighly compensated employees elect family coverage. Is this benefit discriminatory? The price structure is the same for all employees. The results may actually be based on the fact that more of their nonhighly compensated employees are unmarried or have working spouses with their own employer-provided benefits. Yet, unless colleges and universities draft, print, distribute, and collect detailed sworn statements from virtually all of its employees, it will fail the average benefits test under Section. 89.

• Some universities do not provide benefits to visiting lecturers. On the other hand, some universities must provide special programs to visiting professors in order to prevent gaps in medical coverage. Both of these practices can result in failing various Section. 89 tests. Should these programs or individuals be penalized?

• There are hospitals, including university hospitals, with two categories of nurses—those who are regular employees and who receive benefits, and those who have elected a higher hourly wage in exchange for a more flexible wart schedule and no benefits. Yet these hospitals fail the 90/50 eligibility test. Should procedures for flexible work schedules be penalized?

Section 89 will prevent many employers and employees from offering and participating in employee benefit programs that have nothing to do with discrimination. Moreover, the serious and damaging problems created by the Section 89 rules will not be alleviated by cosmetic technical changes to Section 89.

2. SECTION 89 IS PERCEPTIVELY DIFFICULT TO UNDERSTAND AND APPLY

Section 89 may not, on the surface, appear as horrendous as the testimony you have heard. However, do not underestimate Section 89 because there are literally hundreds of secondary tests and rules that accompany the standards to be met. These rules constitute an interpretive and administrative nightmare.

One problem faced when trying to comply with the Section 89 rules is the lack of clear and complete guidance. The recently issued IRS regulations are over 40 pages long and yet fail to address some of the major Section 89 questions such as how to apply the rules to group term life plans and to former employees. In addition, we are concerned about the cost versus benefits associated with these regulations. The complexity of Section 89 needs to be carefully weighed in terms of its administrative burden, costs, and potential for lost benefits to employees. The cost burden associated with the Section 89 regulations would far outweigh any possible social benefits.

The administrative burden requirements located on page 9461 of the Section 89 proposed regulations grossly underestimates the required actual time for keeping records, learning about the law, and computations and tests. The IRS estimated annual "per respondent/record keeping" of "from 1 hour to 40 hours, depending on individual circumstance, *with an estimated average of 10 hours.*" Personnel and benefit professionals in higher education have stated that it requires at least 40 hours to develop an adequate understanding of the law and regulations. This is prior to beginning to compile and test the reams of data needed to comply with Section 89.

The Section 89 regulations appear to be written far consultants, actuaries, and lawyers who may already have an understanding of the complexities of these issues. Even though these professionals will have to be used extensively to implement the law because of its unintelligible complexity, we believe the regulations should stand by themselves as a comprehensive source of information and guidance for personnel directors, business officers, and benefits administrators.

You have heard much testimony about how difficult it is to apply Section 89. The basis for many of these complaints lies in the sizable data collection requirements created by Section 89. In order to apply the Section 89 tests, an employer must maintain at least 50 different pieces of information about each employee. This information must identify the employee, the plans he or she is eligible for, and the plans he or she participates in. This information must not only be maintained—it must be maintained on a computerized data base that can be tested. Moreover, the employee data base must be supplemented by plan data. This plan data must relate to the employee data, so the employer can determine which employees are eligible for each plan and which employees participate in each plan. The problems inherent in obtaining, organizing, and analyzing this data are staggering for a large number of employers.

3. SECTION 89 IS A MASSIVE DIVERSION OF RESOURCES

Colleges and universities have already spent millions of dollars in obtaining the outside assistance necessary to understand and determine what must be done to meet the requirements of Section 89. In addition, higher education institutions will have to dedicate hundreds of hours of employees' time in order to obtain and analyze the data necessary to comply. And what will be the result of this effort? Most colleges and universities anticipate that they will pass the Section 89 tests. Thus, the investment required under Section 89 will serve only to prove compliance with Section 89, but one must look at the costs. The out-of-pocket expenses to meet Section 89 are significant and internal resources will have to be diverted from their tasks—the design, implementation, and administration of our employee benefit programs. The increased costs may have to be covered largely through increased tuitions and other student fees. This is not a gratifying outcome at a time when many feel that student fees are already increasing too rapidly.

4. SECTION 89 LIMITS EMPLOYEE BENEFITS

College and university employees enjoy a wide range of benefits and they also what the right to exercise control over their choice of benefits. Employees needs change, and they want their employee benefit programs to have the flexibility to respond to the changes.

Section 89 currently penalizes cafeteria plans and flexible options plans whereby hampering the employer's ability to address and meet there employee's needs. An employee may want to select an inexpensive catastrophic accident and health plan and use the savings for other purposes. Yet, if the employee is nonhighly compensated, the employer's Section 89 test results suffer.

CONCLUSION

Section 89 imposes a rigid viewpoint of what benefit designs are "deserving" of tax-favored treatment. This rigidity is inherent in the basic structure of Section 89, and the problem cannot be resolved by token attempts at simplification. In the case

of each of our concerns, Section 89 causes problems that can be eliminated only by significant simplification.

Colleges and universities will gladly participate in efforts to further the policy goals of Section 89. However, the basic structure of Section 89 is so burdensome that it is more likely to prevent meeting these goals in its current form. We strongly urge the Senate Finance Committee to repeal or drastically revise the rules to take into account the many problems and concerns outlined above. We need flexibility to develop employee benefit plans to best serve our employees and rules that will allow us to know that plans are nondiscriminatory because of their design. In this way, we can provide employees with the opportunity to choose benefit programs that meet their particular needs, hold costs down and, therefore, minimize the impact on student fees.

STATEMENT OF THE NATIONAL ASSOCIATION FOR HOME CARE

Mr. Chairman and Members of the Committee, thank you for this opportunity to submit a statement for the record on the Section 89 nondiscrimination rules. The National Association for Home Care (NAHC) is the nation's largest professional association representing approximately 6000 home health agencies, homemaker-home health aide organizations and hospices.

NAHC has serious reservations about the impact of Section 89 on home health care provider organizations. These concerns stem from the industry's current small-business structure and the payment limits imposed by most government based payors. A major portion of home care services is reimbursed by Medicare, Medicaid, and state programs for the elderly and disabled.

The majority of home care agencies are small businesses which wall find the reporting and compliance requirements of Section 69 burdensome. Large employers have resources that generally ease the burden of compliance with Section 89. Small employers, on the other hand, do not have the specialized tax assistance that is needed to guide them through the intricacies of the new law. Compliance and reporting pose an even greater burden on home care agencies than on other small businesses since the costs of compliance have not been considered in the Medicare cost caps. Home care agencies, whose costs of caring for Medicare patients exceed these caps, have no means to recoup these extra costs.

At present, the government payment sources do not include, an allowance for the cost of complying with Section 89. They do not consider the study which every employer will have to conduct to comply with Section 89. This study will be expensive for large and small employers alike. Employers will need to seek costly legal and accounting assistance in order to assure appropriate compliance. These costs have not been considered in setting the cost limits for home care agencies. Moreover, the cost of extending the benefits themselves to employees so as not to have discriminatory plans has not been recognized in the payment limits. Other home care programs also include reimbursement limits for home care visits. As in the case of Medicare, payments by such program may not exceed a set limit regardless of actual costs incurred by the agency.

NAHC supports the goal and intent of section 89, but cannot support the current structure and requirements of the provisions due to the potentially severe impact on home care providers. We appreciate the opportunity to submit this statement and stand willing to assist the Committee in modifying the Section 89 rules to maintain its laudable goals while eliminating its negative and costly impact on business.

STATEMENT OF THE NATIONAL ASSOCIATION OF REHABILITATION FACILITIES

Dear Mr. Chairman: This letter is submitted on behalf of the National Association of Rehabilitation Facilities (NARF). NARF is the primary national organization representing community-based nonprofit rehabilitation facilities that provide rehabilitation, training and placement and residential services to persons with mental or physical disabilities. Many of our vocational members employ less than twenty-five (25) people. Work is often an important part of the rehabilitation and training process for these people. There is a great deal of confusion surrounding Section 89. NARF has been inundated by calls from concerned members. Some callers think that mandated health benefits legislation has been passed; others have heard conflicting reports about what is required under Section 89 and all want to know what they should do.

We commend the Chairman and this committee for addressing concerns about Section 89. Several measures have been introduced in the Senate (S. 654, S. 595, S. 89, and S. 350) and the House, particularly H.R. 1864.

The purpose of Section 89 was to encourage employers to expand similar benefit plans to all employees. The consideration and enactment of this provision have occurred at the same time that efforts have been made to increase health care coverage for the employed, as well as the unemployed. Unfortunately, Section 89 may have the ironic effect of impeding, rather than encouraging, these efforts. The provision has proven to be inordinately complex in its understanding, places a tremendous reporting burden on facilities, and data collection. The information would be used to determine whether benefit plans are discriminatory and, if so, the additional income that must be imputed to highly compensated employees (if any) who receive the discriminatory employer-provided benefits. Employers must maintain detailed personnel records identifying employees and dependents by a variety of categories and very few small rehabilitation facilities are equipped with data bases to handle this task. The regulations issued on March 7 by the Internal Revenue Service have done little to clarify numerous questions raised by the statute.

Since Section 89 was passed it has raised an enormous level of concern among both our vocational and medical rehabilitation facility members. Medical facilities, as with many other employers, are concerned about the general interpretation of Section 89. Vocational rehabilitation facilities in addition to having this level of concern have unique concerns regarding whether some workers with disabilities are to be considered employees for purposes of Section 89. It is this area in which we have our most serious concerns. Even though the Treasury Department has announced it will delay the beginning date for testing plans for compliance until October 1, these concerns remain.

There are two basic concerns that have been raised in the context of the vocational facilities. The first as noted, is the definition of who constitutes an employee for purposes of Section 89. The second question is who, among types of employees, should receive a different type of treatment under this section for reasons that are addressed below or who should possibly be excluded from the nondiscrimination rules of Section 89. The IRS recognized this issue in its March 7 regulations and invited comments on the question of excluding certain categories of employees, including those in sheltered workshops.

With respect to the issue of who is an employee, the IRS has addressed this issue with regard to the employment status of clients/ workers receiving training and rehabilitation for purposes of FICA and Federal Income Tax withholding in Revenue Ruling 65-165. In summary, that ruling stated that where the training was to "rehabilitate and protect" and where there is no agreement to form an employment relationship there is not the "degree or kind of direction and control" that is necessary to establish an employer-employee relationship. In coming to this conclusion, the IRS reexamined the master servant test in common law. Also in that ruling, the IRS said that with longer term sheltered workers there was an employee- employer relationship evidenced by vacations, bonuses, and discharges for unsatisfactory work.

Subsequent to this revenue ruling there have been several private letter rulings dealing with additional fact situations and coming to similar findings. These include a Private Letter Ruling 8703014. We believe this distinction is logical and should continue. However, the IRS has not addressed this issue in the regulations, leaving 5,000 affected rehabilitation facilities in a total quandary, with the possibility for grave financial repressions. Section 89 raises other problems for people in vocational rehabilitation facilities who are employees. It seems implicit in Section 89 that employers are hiring employees because it is in the employer's interest to do so. In providing work and incomes for disabled people, vocational rehabilitation facilities are not guided by this motive. Rather, their purpose is a social one, to afford employment and dignity for people with disabling limitations. Under these circumstances the value of imposing the requirements of Section 89 to their client population must be gauged by whether it expands or restricts potential benefits to them.

Most vocational rehabilitation facilities employ staff to provide training, supervision, counseling, and other services to disabled people served by the entity. These employees would and should be covered by Section 89 to the same extent as other employees subject to the law. Persons with disabilities who are served by the facility pose special problems. Application of the tests set forth in Revenue Ruling 65-165 only partially address this problem. Institutions employing large numbers of person with disabilities who have completed a rehabilitation program face difficult choices if Section 89 is applicable to such persons. Many are covered by Medicare and Medicaid.

The economic effect of whether a person is an employee for purposes of withholding or Social Security is quite different from that of mandating participation in health and accident insurance, for example. In the latter case a physically or mentally disabled person may be an uninsurable risk on an individual basis and the presence of a substantial number of such persons in a facility may render the entity itself uninsurable or dictate premium rates that are not economical. Many such persons are entitled to Medicare benefits as a result of being disabled for two years or for Medicaid benefits as a result of their incomes or because they are beneficiaries of the Supplemental Security Income Program under the Social Security Act. There are complex interrelationships between income, disability and physical/mental condition in the eligibility standards and benefits in these programs. For example, the Medicare and Medicaid Acts provide that group or other health insurance is now the first payor. Yet, under certain circumstances persons with disabilities are allowed to retain Medicaid coverage while working after periods of rehabilitation or in a sheltered environment. (See Section 1619, Social Security Act.) There are over 5,000 affected rehabilitation providers serving well over 400,000 people in these categories.

In some cases special waivers have been granted to permit them to work without loss of these publicly supported health care programs. Requiring that the rehabilitation facility cover the full cost of such insurance will likely force, not the expansion of benefits for clients with disabilities, but rather the elimination of benefits for staff.

We do not have sufficient information on the contemporary practices of various facilities to provide a comprehensive statistical analysis of this problem, but it certainly exists. It is compounded by the fact that persons with disabilities often are uninsurable or are insurable only at high rates and with "preexisting condition" exclusions. It is unclear whether such an exclusion would be regarded as discriminatory per se under Section 89. It would also be a cruel irony if Federal law made the staff of a rehabilitation facility uninsurable as a group or priced them out of the market by requiring inclusion of disabled clients, who in many cases are covered by public programs. NARF supports provision of benefits especially health benefits, for persons with disabilities but does believe the Internal Revenue Code is the proper forum for tackling this problem.

We strongly suggest that persons served by rehabilitation facilities be excluded from Section 89 as not being the type of "employees" to which the law is addressed. We suggest that this exclusion extend to both persons in active training programs and those in sheltered or supported employment programs. At a minimum, certain definable populations should be excluded. These should logically include persons employed under Labor Department certificates pursuant to Section 14(C) of the Fair Labor Standards Act, persons receiving Supplemental Security Income payments, persons receiving Social Security Disability Insurance benefits and persons otherwise qualified for state Medicaid benefits. These groups are not exhaustive of the persons served in vocational rehabilitation facilities, but they constitute a considerable portion thereof.

It is our intention to supplement these comments as further information on the matter is developed. It is urgent that Section 89 not result in losses of benefits for current staff and impairment of services to persons with disabilities. To do so would defeat some of the original intent of Section 89. Those are the likely results of application of the law to clients in programs operated by vocational rehabilitation facilities. We recommend that H.R. 1864 be amended to assure that it does not inadvertently have the same result as current law.

Therefore in summary, NARF makes the following recommendations for final action to amend Section 89:

1. NARF is requesting that the Committee direct the Internal Revenue Service to issue a ruling defining employees for purposes of Section 89, using Revenue Ruling 65-165 and subsequent private letter rulings as the basis for this regulation. Such a regulation should note that where the purposes of work is therapeutic and is part of a rehabilitation plan for the individual and the individual is not producing at levels that would be expected of regular employees and the other indicia of an employment relationship are not present then the person with a disability would not be considered an employee for the nonprofit service provider for purposes of Section 89.

2. NARF recommends that certain categories of employees be excluded for purposes of Section 89 only. As noted we suggest that this exclusion extend to persons in active training programs and those in sheltered or supported employment programs. At a minimum, certain populations should be excluded. These are persons employed under the Department of Labor certificates issued pursuant to Section 14(c) of the Fair Labors Standards Act, persons who are receiving Supplemental Se-

curity Income payments, persons receiving Social Security Disability Insurance Benefits, and persons otherwise qualified for state Medicaid benefits. While this is not an exhaustive list as noted above it constitutes a number of the persons served in vocational rehabilitation facilities.

3. NARF recommends the Committee seek to delay the effective date of this provision until one year after final regulations are promulgated with a statutory deadline for such final regulations based on any change in the statute made by the Committee. This would allow adequate time for all affected parties to have a better understanding of the final statute and any final regulations.

STATEMENT OF THE NATIONAL ASSOCIATION OF STATE AUDITORS, COMPTROLLERS, AND TREASURES

I am testifying today as president of the National Association of State Comptrollers which is part of a larger umbrella organization, the National Association of State Auditors, Comptrollers and Treasurers. NASACT, as the name implies, is an association comprised exclusively of over 130 state fiscal officers, approximately half of whom are elected state officials.

Because state comptrollers are the chief accounting officers of their states, the burden of testing compliance with section 89 falls on them.

We are very pleased to have the opportunity to testify today on behalf of state governments and to support the nondiscriminatory objectives of section 89. There are very few, if any, states that have discriminatory employee benefit plans. Unfortunately, perhaps, highly compensated employees are not endemic to state from a survey that we recently conducted, there were several questions about the present section 89 that are not addressed in H.R. 1864.

The questions involve seven areas:

1. Reporting entities
2. Time for compliance
3. Excluded employees
4. Excluded benefits
5. Employee contributions
6. Union agreements
7. District of Colombia

1. REPORTING ENTITIES

State governments consist of three separate but equal branches. Each branch should be tested for compliance as a separate entity. In addition, state legislatures have created specialized boards, commissions and authorities which have the right to set their own salaries and benefit plans. Such units should be responsible for their own compliance with section 89. H.R. 1864 should define "separate lines for business" for governments as it does for the private sector. Nondiscrimination in health and life benefits should apply within each homogeneous unit. We would be glad to work with the committee in defining reporting entities within state

2. TIME FOR COMPLIANCE

Because some benefit plans are established by state legislatures, they would have to be changed statutorily. Generally, the legislative process is slow and some state legislatures meet only every two years. We suggest that governments be given until December 31, 1991 to comply with section 89 if any of their plans prove to be discriminatory.

3. EXCLUDED EMPLOYEES

States operate facilities in which prisoners, students, patients and others work while they are incarcerated, studying or being treated. These types of employees should be excluded from testing requirements because they are not covered by benefit plans.

Inactive, former and retired employees should be excluded if they are not entitled to postemployment benefits, other than pensions, or if the provider of benefits is not controlled by the employer, such as a trust fund.

We do not know what a "leased employee" is. If it means a person who works for a temporary help company, clearly, the employer is the temporary help company and not the government. If it means an independent contractor such as an attorney, engineer, consultant, etc., the government is not the employer either. In both cases,

the testing requirements should be on the employer and not on the government. In both cases, the government treats them as vendors and it would be difficult to distinguish them from other vendors.

4. EXCLUDED BENEFITS

It is not clear as to what constitutes a "tuition reduction agreement." Tuition reimbursements to enhance job-related skills should be excluded. Physical examinations, if required by the job, such as for police officers and fire fighters, should be excluded.

5. EMPLOYEE CONTRIBUTIONS

We would like to suggest that the $10 and $25 employee contributions be indexed to increases in medical care cost and not to wage increases.

Part-time employees should be tested separately. If a part-time employee contributes the same amount as a full-time employee, the part-time employee is paying a larger percent of his or her salary than the full-time employee. For a reduced cost, the part-time employee could be covered for reduced benefits.

6. UNION AGREEMENTS

We recommend that, rather than mandating that union employees be tested separately, the employer be given the option of testing union employees separately or as part of its total workforce.

Because some union contracts run for three years or more, compliance for union employees should be delayed until a new contract is negotiated. because each union contract is negotiated separately, there can be no guaranty of uniformity of benefits or contributions.

7. DISTRICT OF COLUMBIA

Lastly, I would like to talk about a special problem with regard to the District of Columbia and section 89. Up to and through September 30, 1987, District employees enrolled in the federal health and life insurance programs. Employees first hired after that date are covered by health and life insurance plans administered by the District of Columbia. The District cannot test the employees covered in the federal program which is administered by the United States Office of Personnel Management. We would like to suggest that the Federal Government include District employees hired before October 1, 1987 in its testing of its own plans and the District will test its own plans for employees hired on and after October 1, 1987.

If H.R. 1864 addresses the foregoing seven concerns of the state governments, we believe that a fair and equitable law will result.

Our members have a commitment to sound financial planning for their states. This includes a concern for their employees and the provision of equitable health benefits. We urge the committee to provide additional relief to state and local governments in the form of further simplification or exemption.

Thank you, Mr. Chairman. I would be happy to respond to questions.

STATEMENT OF THE NATIONAL CONSTRUCTORS ASSOCIATION

The National Constructors Association (NCA) appreciates the opportunity to address the Finance Committee regarding a subject of great concern to its membership, Section 89. The NCA is made up of many of the nation's largest firms engaged in the design and construction of major commercial, industrial and process facilities worldwide. We initially would like to commend the Committee for its willingness to address the difficulties and complexities within Section 89 to make it workable for both the construction industry and the business community as a whole. The NCA has two principal concerns about Section 89: the treatment of multiemployer plans and the nondiscrimination rules.

1. WHAT ARE MULTIEMPLOYER PLANS?

Multiemployer benefit plans differ from single-employer benefit plans in the way that they are funded and administered. Under a multiemployer plan, two or more employers contribute to a pooled fund on behalf of that part of their workforce covered by a particular contract agreed to through the collective bargaining process. The benefits purchased from the fund are selected and administered, not by the employers, but by independent trustees.

Multiemployer plans are common in certain labor-intensive industries, such as the construction industry. The practice in the construction industry is for employers to request workers through union hiring halls. These workers typically work for many different contractors during the year, often for short periods, and may work for the same contractor several times in the same year. Each contractor keeps pay records only for the periods of employment with that contractor. Pursuant to collective bargaining agreements, these employees may receive medical insurance, life insurance, and other benefits through a multiemployer plan.

Under a multiemployer plan, each employer is obligated by a collective bargaining agreement to contribute a fixed dollar-and-cents amount per hour worked. The employers' contributions are pooled and used by the multiemployer plan trustees to purchase medical insurance and other benefits for the covered employees. Typically, employees are not required to contribute to multiemployer plans. Ordinarily, the contractors and unions do not negotiate the type or amounts of benefits that will be provided. Individual contributing employers exercise no control over multiemployer plan benefit design, such as the division of funds between health and other benefits and the different options within each benefit plan. The trustees are appointed by labor and by management, are independent fiduciaries and do not take instructions from the employers. The trustees select insurance carriers and the types and amounts of coverage provided and can change coverage without the employers' knowledge. Employers are generally unaware of the details of the insurance coverage provided or how the payments are allocated between health insurance, life insurance and other benefits. Further, multiemployer plans are subject to the Taft-Hartley Act and to regulation by the Department of Labor.

2. TREATMENT OF MULTIEMPLOYER PLANS UNDER SECTION 89

The rules of Section 89 do not work well when applied to multiemployer plans. Employers should not be held responsible in particular for meeting the "qualification" requirements relating to the form of plan documents, notification to employees, enforceability of benefits, indefinite maintenance, etc. Generally, the multiemployer plan trustees, who control and administer the benefits, are in a position to see that these requirements are satisfied. Employers simply lack control over plan design and administration of multiemployer plans.

Section 89 requires that a substantial amount of information has to be collected in order to avoid tax penalties. To prove that its plans satisfy the nondiscrimination requirements, an employer would have to determine which employees are highly compensated. The employer would also have to determine the type of health benefits (core coverage, family coverage, etc.) received by each employee, and the value of each type of health coverage.

Multiemployer plans, particularly in the construction industry, cover employees who may work for many different employers during a single year. Neither the plan trustees nor any one of the employers know an employee's total compensation for the entire year. Presumably, determination of whether an employee is highly compensated is based only upon the wages paid by the particular employer. *See* I.R.C. 414(q). If this interpretation should not be correct, and an employee's compensation from all of his different employers must be considered, neither the employer nor the trustees could comply with the statute.

Employers also do not know how much of their contribution to a multiemployer plan will apply to each of the benefits subject to testing. Although Section 89 allows an employer to treat the actual contribution to a multiemployer plan as the "employer-provided benefit," there are troublesome exceptions that could allow this rule to be undermined. Moreover, the employer would still have to calculate the allocation of the contribution among different types of benefits, which requires information that the employer does not possess.

3. THE NONDISCRIMINATION RULES UNDER SECTION 89

Under Section 89, employees who normally work less than 17½ hours per week are excluded from consideration. 17½ hours per week is not a realistic measure of part-time employment in most industries. 25–30 hours per week would better reflect industry practice. Moreover, it is not clear whether this rule excludes all employees who work an average of less than 17½ hours per week or only those who work less than 17½ hours. "Casual" employees may work more than 17½ hours per week during some weeks but few or no hours during other weeks. Unless part-time employees are excluded on the basis of average hours worked, no part-time rule will adequately address the problem of casual employees.

In reality the 90 percent eligibility test is not a nondiscrimination requirement. Nondiscrimination should not mean that a specified percentage of employees must be eligible but only that the percentage of highly compensated employees who are eligible must not be substantially greater than the percentage of rank-and-file employees who are eligible. As applied to a qualified savings plan, for example, the pension plan rules presently require only that the percentage of rank-and-file employees who are eligible be at least 70 percent of the percentage of highly compensated employees who are eligible. A savings plan for which 70 percent of rank-and-file employees were eligible would automatically qualify. Moving the Section 89 rules towards the qualified plan model would provide adequately for nondiscrimination without, in effect, mandating universal coverage.

The legislation introduced in the House of Representatives, H.R. 1864, would introduce a ceiling on employee contributions as a test of nondiscrimination. In principle, the NCA has no objection to such a test, provided that this test would truly replace most of the onerous percentage tests that apply under current law and provided that the ceiling is properly indexed. The House legislation falls short by preserving the 90% test and in using an inadequate inflation index.

4. RECOMMENDATIONS

Multiemployer benefit plans collectively bargained in good faith should be excluded from both the nondiscrimination and qualification rules of Section 89.

The definition of part-time employees should be changed from 17½ hours per week and should be clarified to include any employee who works an average of 25 hours or less per week during the testing year.

The 90 percent eligibility requirement should be reduced to 70 percent and/or the eligibility requirement should be satisfied by any employer that provides core health coverage to comparable percentages of highly compensated and rank-and-file employees.

Any ceiling on employee contributions to qualified core health plans should be tied to an index that realistically represents increases in the cost of health coverage. We advocate using the increase based on a reasonable percentage of insurance premiums as a good index. In addition, we recommend that the law make clear that contributions to pay for coverage that must be offered to comply with the health care continuation coverage requirements of COBRA should be disregarded for this purpose.

The NCA appreciates this opportunity to address the Committee regarding its concerns about Section 89.

STATEMENT OF THE NATIONAL CONVENIENCE STORES, INC.

(Submitted by V.H. Van Horn, President and Chief Executive Officer)

Mr. Chairman and members of the Committee, I am Pete Van Horn, President and CEO of National Convenience Stores, Inc., based in Houston, Texas. I am here today not only on behalf of my company, which employs over 8,000 workers in the state of Texas, but also on behalf of the National Association of Convenience Stores, of which I am a former chairman of the Board. NACS is a trade association representing 2300 companies operating 54,000 convenience stores and providing over half a million jobs.

Although NACS represents convenience store companies of all sizes, I'd like to take a few moments to profile the typical NACS member. According to a 1987 survey, 60 percent of NACS retail members are companies with 10 or fewer stores. Those companies own an average of just over four stores and employ an average of approximately 30 employees.

Fully 88 per cent of NACS retail members are companies with fewer than 50 stores. Those companies own an average of roughly 10 stores and employ on the average fewer than 100 employees.

Given those numbers, I feel secure in saying that few, if any, industries have felt the impact of Section 89 as harshly as the convenience store industry since the law took effect on January 1. On behalf of the industry, I want to thank you for holding these hearings, and we hope the Committee recognizes that changes in Section 89 are imperative.

The purpose behind the law was, as NACS understands it, in two parts. Congress believed that the bill would encourage employers to extend their health and life insurance benefit plans to more employees and not limit coverage to higher-income workers. The bill also had a revenue-generating purpose, as tax revenue would be

generated from discriminatory benefit plans as well as from plans that do not meet the new qualification rules for tax-free status.

After fewer than five months of operating under the law it is not clear that it effectively serves either purpose. Indeed, NACS believes that the two goals were mutually exclusive from the beginning. If the law succeeds in inducing employers to offer benefits to more employees, benefit plans will become non-discriminatory and will generate no revenues for the federal treasury. On the other hand, if employers continue to eliminate benefit plans entirely to avoid the costs and uncertainty of discrimination testing, tax revenue will increase, but so will the number of uninsured Americans.

The convenience store industry is concerned over aspects of both the nondiscrimination tests and the qualification rules of Section 89. Although there seems to be broad support for changing the discrimination testing, we are concerned that the qualification rules will be left alone. We echo the comments of many other business groups that have objected to Section 89, and we would like to explain the effects of the law on our industry.

The convenience store industry does not operate on a high profit margin. Any added costs of doing business are either passed on to the consumer or, if absorbed by a company, result in the elimination of unprofitable stores and the jobs they created.

Section 89 imposes substantial costs on the convenience store industry. Simply determining whether a covered benefit plan discriminates in favor of highly-compensated employees can cost even a small company $10,000 or more. That cost will be duplicated for each separate plan a company offers. As the law says that even a slight difference in benefits provided under a plan can have the effect of treating one plan as two or more, the costs imposed by Section 89 on small companies are far more disproportionate to the purposes it serves. Many smaller companies will not be able to survive the costs imposed by the law.

It is obvious from my opening remarks concerning the size of the average convenience store company that NACS is concerned as an association about the impact of Section 89 on small businesses. We do not believe, though, that the unfairness of the law is limited to smaller companies. Large convenience store chains also are affected by Section 89 in ways that hurt their ability to complete in the marketplace. Larger companies have more employees and may offer a greater variety of benefits than small companies. As a result, their costs of discrimination testing are magnified.

In addition, many convenience store chains operate in more than one state or more than one geographic region. Section 89's penalties for not offering comparable benefits to lower and higher income employees fails to take into account regional difference in costs of living and other economic considerations. In order to compete for workers in some parts of the country, a chain may have to offer costly fringe benefits to prospective employees. Penalizing the same chain for not offering similar benefits to workers in other parts of the country where competition for workers is not as high, while not penalizing local food retailers which also may not offer any benefits, can pose an almost insurmountable competitive disadvantage on the larger chain. The result would be to force the larger chain out of some markets and to eliminate jobs from economically disadvantaged regions.

Other federal laws allow for regional differences in compensation. The Davis-Bacon Act, for example, requires federal construction contractors to pay their employees no less than the wages that are prevailing for similar work in the same "city, town, village, or other subdivision" in which the work is to be performed. Similarly, the Walsh-Healey Government Contracts Act and the Service Contract Act require other federal contractors to pay employees no less than the wages that are prevailing for similar work in the same "locality." The failure to take that into account in Section 89 imposes substantial hardships on large chains and their employees.

The most devastating impact of Section 89 has been the decision of many companies to discontinue their employee benefit programs entirely rather than face the uncertainty and potentially disastrous tax liabilities of the law. Obviously, this approach takes benefits away from lower income employees who may not be able to afford to buy their own, and defeats one of the purposes of the law. Further, there is no guarantee that even higher-paid workers will use the additional income to purchase health insurance. The result will surely be an increase in the number of uninsured Americans.

The only way to resolve completely the problems created by Section 89 is to repeal it in its entirety and start on a clean slate. Section 89 has so many fundamental complexities and inequalities that any effort to amend it short of a complete

repeal would be meaningless and would only add to, rather than subtract from, the severe problems it creates. NACS favors a complete repeal of Section 89, and would be willing to work with Congress to develop a workable alternative.

The qualification rules, although not as complex as the non-discrimination rules, are probably more inequitable. The effect of those rules is to tax all benefits received by even low income employees through no fault of their own if their employer made a mistake in implementing the plan. A failure to comply with the qualification rules will result in the taxation of all benefits received under the plan. An employee earning $13,000 per year at a company which provides benefits to lower-paid workers may find that every dollar received in benefits is taxable income. The Internal Revenue Service regulations establish limits, based on income, that any individual will be required to include in taxable income, but those limits appear nowhere in the statute. NACS believes that the qualification rules are too harsh, too burdensome, and unnecessary to serve the law's purposes.

The bills introduced to date in the Senate to amend Section 89 fall far short of providing the necessary relief from the burdens imposed by the law. Both of those bills—S. 595 and S. 654—leave intact the vast majority of Section 89 and merely carve out minor changes in its provisions. H.R. 1682 also proposes only minor changes in Section 89.

Short of a complete repeal, NACS must agree with the approach taken by Mr. Rostenkowski in the House. His bill, H.R. 1864, proposes to rewrite completely the discrimination provisions of Section 89. Although NACS does not agree with the provisions in Chairman Rostenkowski's bill imposing an excise tax on employers for plans that fail to satisfy the qualification rules, and although NACS would like the opportunity to work with the Congress in developing the final bill, NACS is in agreement that a total revision of the discrimination rules is necessary to make the law workable and less burdensome on employers. If that is done, NACS believes Section 89 will no longer induce employers to discontinue health benefits in favor of higher salaries for high income employees, and will achieve some of the purposes of the original bill without imposing undue costs on employers.

Thank you, Mr. Chairman and members of the Committee.

STATEMENT OF THE NATIONAL COORDINATING COMMITTEE FOR MULTIEMPLOYER PLANS

(Submitted by Robert A. Georgine, Chairman)

My name is Robert A. Georgine and I am testifying in my capacity as Chairman of the National Coordinating Committee for Multiemployer Plans.

The Coordinating Committee was organized shortly after the passage of ERISA in 1974, to represent the interests of the more than nine million working men and women, and their families, who are covered by multiemployer plans. The Committee's affiliates include more than 190 pension funds, health and welfare funds, and related international unions.

We support the approach of H.R. 1864 ("Bill"), which is being considered in the House, to simplify the extraordinarily complex nondiscrimination rules applicable to employee welfare benefit plans under section 89 of the Internal Revenue Code. If interpreted and implemented in an appropriate and workable fashion, this Bill would vastly simplify the testing burdens imposed on most employers contributing to multiemployer plans. However, if interpreted or implemented without due regard to the unique nature and circumstances of multiemployer plans, the Bill could impose insurmountable burdens on multiemployer plans and be completely unworkable. Thus, the primary purpose of my testimony is to describe the unique nature of multiemployer plans and the interpretation of the Bill that is most appropriate and workable for such plans.

In addition, I would like to point out that, under current law, employers test the coverage they provide to members of a collective bargaining unit and the coverage they provide to other employees together. In some cases, the result is that the coverage an employer provides under a multiemployer plan helps the employer to satisfy the Code section 89 requirements with respect to other, nonmultiemployer plans. We suggest that you give consideration to permitting employers to elect to test their collective bargaining unit members and their other employees together for this purpose. However, the increased burdens of such combined testing should not be imposed on employers that do not elect it.

Finally, I will suggest a few technical changes to make the section 89 rules more workable for multiemployer plans.

I. THE UNIQUE NATURE OF MULTIEMPLOYER PLANS

One of the things that makes multiemployer plan coverage unique from a section 89 perspective is the independence of the plan from any particular contributing employer. The plan's trustees design and administer all aspects of the benefit program. They set the eligibility rules, determine the specifics of coverage (covered services, coverage limits, etc.), decide whether the plan is to be insured or self-insured, etc. The plan may have hundreds of contributing employers. Some plans have contributing employers numbering in the thousands. A contributing employer typically does little more than send in its periodic contributions with whatever backup information is required to enable the plan to identify the employees to whom the contributions relate.

Employers, other than those on the boards of trustees, typically are not well informed about the details of the coverage provided under the multiemployer plans to which they contribute. Many of them may be contributing under agreements produced through collective bargaining in which the individual companies did not participate, because it was handled on their behalf by employer associations. Employers ordinarily do not have sufficient information to value the coverage provided to their employees for purposes of the section 89 nondiscrimination tests.

Another distinguishing characteristic of most multiemployer plans is the mobility of the employees they cover. Often their participants will only work for a brief period for any one contributing employer, though they are working continually in the industry during the year. For example, a construction worker may work for various contractors during a month, moving from one to another as he completes the specific job for which he was hired on each project. Many of these employees would never qualify for health coverage from any one employer. The multiemployer plan adds up their short periods of service with each employer and gives them coverage based on the aggregate.

Multiemployer plans are, by definition, maintained pursuant to collective bargaining agreements. The overwhelming majority of their participants are union-represented rank-and-file workers. Typically, only a small proportion—if any—of these workers are highly compensated employees. The plans provide uniform benefits in relation to contributions,[1] are virtually always noncontributory (100% employer-paid), and rarely, if ever, offer individual employees different coverage options (other than an HMO option).

Multiemployer plans do not have and ordinarily cannot get information about their contributing employers and their workforces necessary to test for compliance with Code section 89. The plans do not have information on the management structures of contributing employers or on the salaries and pay scales of employees, including employees who are not covered under the plan. In addition, they do not have information about leasing or affiliated service group arrangements in which contributing employers may be involved. They therefore cannot determine which, if any, covered or noncovered employees of those employers are highly compensated.

Contributing employers would be extremely resistant to providing this information to the plans, the boards of trustees of which are required by law to be made up 50 percent of union representatives and 50 percent of employer representatives who, in most cases, are highly placed in the management of competitors of contributing employers. Further, as a practical matter, it would be impossible to compile and process this information for the hundreds of contributing employers that participate in the typical multiemployer plan.

Plans also do not have information about other plans maintained by contributing employers. Thus, they cannot determine whether those other plans cover individuals who would otherwise be excludable for purposes of section 89 testing. Such coverage would prevent similarly situated employees in a bargaining unit covered under a multiemployer plan from being excludable. Similarly, contributing employers would have no knowledge of or control over the plan's eligibility rules.

In addition, multiemployer plans have a fixed income. In the section 89 context, this is significant both from the employers' and the plans' perspectives. These plans are funded based on contribution rates fixed in collective bargaining agreements, which typically require employers to contribute a set amount based on some meas-

---

[1] Some plans, particularly regional or national plans, offer different benefit packages for different rates of employer contributions. The choice is not made by individual employees, but by the various employers and unions through bargaining. Thus, for instance, if one group negotiates a $0.75 per hour contribution, that might entitle the employees of that employer to benefit plan A, while a $1.00 per hour contribution rate would make them eligible for the more generous benefit plan B.

ure of the activity of covered employees. The standard, for example, is a requirement of $x per hour worked by an employee covered by the bargaining agreement. Those contributions are payable, typically, on all employees in the bargaining unit without regard to their coverage under the plan (This contrasts with an insured single employer health plan, where the employer does not pay premiums on behalf of an employee until the employee is covered. Of course, in a self-funded single employer plan, employer contributions are generally made as covered employees incur claims.) On the other hand, because of multiemployer eligibility rules, coverage is provided under the plan for some people for whom employers make no contributions.

From the plan's point of view, it is important that the employers only contribute what the collective bargaining agreements require them to, even if it turns out that the plan actually needs more. If the information that employers need for section 89 compliance is difficult and expensive for plans to develop, it could create real hardships for plans to provide it. Even if plans had the capability of assembling section 89 data, some may not be able to afford it without cutting the level of coverage.

II. A WORKABLE SEPARATE TESTING RULE

We support the approach taken in the Bill, to provide for separate testing of bargaining units. The current law nondiscrimination rules make a dramatic departure from established policy, in that they require employers to count the benefits provided to union-represented workers through multiemployer plans in testing whether their other benefits are discriminatory. The NCCMP believes this approach is wrong as a matter of principle. We believe employers and unions should be free to bargain in good faith on behalf of one group of employees without affecting the pay or benefits of others working for the company.

A. Multiemployer Plan Valuation Rules

We are also encouraged to see that the Bill includes the special rule of current law permitting an employer to treat the contributions it makes to a multiemployer plan on behalf of an employee as the employer-provided benefit of such employee under the plan. As we understand it, an employer would be treated as providing coverage to (and only to) the employees with respect to whom it actually made contributions. The value of that coverage for a testing year would be the hourly rate of the contributions paid on the testing day, computed on an annualized basis. Multiemployer plan participants with respect to whom an employer does not make contributions are treated as not covered. These include, for example, retirees and former employees.

This rule is crucial to workable section 89 testing of multiemployer plan benefits. As discussed above, the plans and the contributing employers are completely independent of one another. Typically, an employer's involvement with a multiemployer plan begins and ends with the periodic payment of the contributions required by the collective bargaining agreement. The plans' labor-management boards of trustees establish the plan of benefits. They determine eligibility and coverage rules, financing, etc. Most employers, other than those on the boards of trustees, are not well informed about the details of the specific benefits the multiemployer plans provide, or even which of the employees with respect to whom they contribute are actually covered under the plan. Indeed, they would have no need for that specific information in running their business.

An employer that is aware of all of the details of the specific coverage rules and benefits of a multiemployer plan to which it contributes would still be unable to determine which of the employees with respect to whom it contributes are actually covered. This is because, as discussed above, coverage under a multiemployer plan depends on service with all employers contributing to the plan. The specific employer for which an employee is working at the moment will not have information about that employee's service with other employers. Further, in many multiemployer plans, there are "hours banks" that permit employees who have had more hours than necessary for coverage during one period to push some of those hours forward to obtain coverage in a subsequent period during which the employee would otherwise not be covered. Again, an employee's current employer would not necessarily be aware of that employee's past service for another contributing employer that can be used for this purpose.

The special multiemployer plan rule permits employers to test for section 89 compliance based on information they have available. The only information a typical employer has is the contribution he makes per employee. It is therefore appropriate to permit such employers to test on this basis. In addition to being a workable solu-

tion, such testing, in the typical multiemployer plan, provides a good approximation of the results that would be obtained if actual coverage were tested.

B. Application of the Multiemployer Plan Valuation Rule to the Bill's Tests

We urge you to retain the multiemployer plan valuation rule discussed above for purposes of any revised section 89 rules. In particular, in the context of a separate testing approach such as that that would be provided under the Bill, we urge you to provide that this special rule would be applied as follows. (The following example is based on the nondiscrimination test set forth in the Bill, but could be adapted to whatever nondiscrimination test the Senate develops.)

1. Employer-Based Testing

First, and most importantly, the responsibility to test for compliance with the nondiscrimination requirements of section 89 should remain with each individual employer contributing to a multiemployer plan. As discussed above, plans do not have, and ordinarily cannot get, information relating to management and salary structure of employers, employees not covered by the multiemployer plan, and other plans maintained by employers, all of which is crucial to section 89 testing.

On the other hand, only the employers have access to information necessary to determine which, if any, of their employees are highly compensated. Contributing employers have information about the other plans they maintain. They will prepare the Forms W-2 for their employees and are therefore the appropriate parties to determine section 89 compliance and, if necessary, to include additional amounts in employee income for purposes of FICA and federal income tax. Finally, thanks to the multiemployer plan valuation rules described above, the employers have information, in the form of required contributions, necessary to value the coverage provided under multiemployer plans to which they contribute.

2. The Testing Process

a. A Bargaining Unit That Includes No Highly Compensated Employees Should Automatically Pass the Tests.—Each employer would proceed to test as follows: The employer would determine, based only on compensation paid by that employer (without reference to compensation paid to any of its employees during the year by any other employer, regardless of whether or not such other employer contributes to the same plan), which of its employees in a particular collective bargaining unit are highly compensated. If there are no highly compensated employees in the collective bargaining unit being tested, the section 89 requirements should be satisfied with respect to that bargaining unit.

b. Bargaining Units Including Highly Compensated Employees.—If there are one or more highly compensated employees in the collective bargaining unit, the employer will then have to pass the following three tests.

(1) The employer is required to make contributions for at least 90 percent of the nonhighly compensated employees in the collective bargaining unit, other than excludable employees.

(a) For this purpose, the determination of which employees are excludable should be made separately for different bargaining units and for the nonbargained group. Thus, for example, the fact that a multiemployer plan has no minimum service requirement should not affect the excludability of short service employees under other plans maintained by the employer and vice versa. Under current law, multiemployer plan eligibility rules do no affect employers' exclusions. It should be made clear that separate testing for union-represented employees under H.R. 1864 leads to the same result.

(b) In addition, for this purpose, a determination of whether an individual is excludable as a part-time worker should be made on the basis of annualized hours or other equivalences. Thus, for example, if an employee did not have thirteen hundred hours of service (25 hours times 52 weeks per year) during a testing year, that employee would be excludable as a part-time worker. If plan eligibility is measured on a monthly basis, 100 hours would be the equivalent exclusion threshold.

(2) The plan does not require either pre- or post-tax employee contributions above the levels specified in the Bill for any active employees (excluding contributions for COBRA coverage). An employer should be deemed to satisfy this requirement if it obtains written assurance from the plan that no such contributions are required. We note that it would be useful to make it clear, in legislative history or statutory language, that COBRA contributions are not relevant.

(3) The employer must not pay an hourly contribution rate for any highly compensated employee in the collective bargaining unit that is more than 133 percent of

the highest contribution rate paid by the employer for 90 percent of the nonhighly compensated employees in the collective bargaining unit.

Note that the special rules for multiemployer plans discussed above require the employer contributions to be adjusted, for purposes of section 89 testing, if the allocation of plan benefits between highly compensated employees and other employees under a multiemployer plan varies materially from the allocation of employer contributions to such plan. This adjustment will provide a basis for necessary adjustments for entertainment and a few other industries where employer contributions are set at a percentage of pay, rather than on a cents-per-hour or similar basis, but coverage is nevertheless uniform. Thus, in these few special situations, employer contributions provide a grossly exaggerated estimate of the value of coverage provided to highly compensated employees.

If the contributions the employer makes with respect to employees in a collective bargaining unit pass all three of the tests described above, no additional amount will be included in the income of any highly compensated employee of the employer.

We believe that, if interpreted and implemented as described above, the Bill would provide appropriate and workable rules for testing coverage under multiemployer plans for compliance with section 89. We are confident that virtually all multiemployer plan coverage will comply with the new rules on this basis. The problems our plans have had with the section 89 rules do not arise due to any discrimination or abuse within the plans. These plans are not discriminatory. The vast majority of their participants are rank-and-file union workers, who are not highly compensated and the benefits for those in each bargaining unit are uniform. The problem, instead, has been the enormous, and, in some cases, virtually impossible, burden of testing this coverage to prove that it is, in fact, nondiscriminatory.

3. Definition of "Professionals"

Under the Bill, the special multiemployer plan valuation rule described above would not apply to any employer maintaining a multiemployer plan "if such employer makes contributions to such plan on behalf of any individual performing services in the field of health, law, engineering, architecture, accounting, actuarial science, financial services, or consulting or in such other fields as the secretary may prescribe." Similarly, separate testing of bargaining units would not apply to a bargaining unit more than a de minimis number of the employees in which "perform services in the field of health, law, engineering, architecture, accounting, actuarial science, financial services, or consulting or in such other fields as the secretary may prescribe."

This language, however, could be construed to include a far broader group of individuals than the professionals it is intended to define. For example, orderlies, nursing assistants, and other nonhighly paid individuals perform services in the health field. Unions, plans, and some contributing employers may employ staff attorneys who are not highly paid, but who perform services in the field of law.

Accordingly, we suggest that the intent of this provision would be better served if the group were defined as follows:

> "professional employees who on any day of the plan year perform professional services for the employer as a certified or other public accountant, actuary, architect, attorney, chiropodist, chiropractor, investment banker, medical doctor, dentist, optometrist, osteopath, podiatrist, engineer, psychologist, stockbroker, veterinarian or in such other professional capacity determined by the secretary."

Similar language has been proposed by the Department of the Treasury to implement nondiscrimination provisions for pension benefit plans.

In addition, we suggest that this group be limited to individuals who are highly compensated within the meaning of Code section 414(q). This will achieve the desired result of preventing discrimination in favor of highly paid professionals, while making this needed relief available to other groups.

We also suggest that, for purposes of both the special multiemployer plan valuation rule and the separate testing rule, the "professional" rule be applied on a bargaining agreement by bargaining agreement basis. Thus, the denial of the special rule to a bargaining agreement that includes professionals would not preclude the employer's use of the special rule with respect to other bargaining agreements covered under the same multiemployer plan, if such other agreements did not cover professionals.

Finally, we suggest that, for purposes of both the special multiemployer plan evaluation rule and the separate testing rule, a two percent de minimis rule should apply for purposes of the "professional" rules. Thus, if not more than two percent of

the employees in a bargaining unit are "professionals," the bargaining unit should be treated as not covering professionals and the special valuation and separate testing rules should be available with respect to that unit. This is included in the Bill's provision for separate testing for union- represented employees, and in proposed Treasury regulations for pension plans.

III. ELECTIVE COMBINED TESTING

As noted above, we believe that separate testing of collective bargaining units is appropriate, both because of the special considerations that apply to a collective bargaining situation and because of the practical problems that arise in testing multiemployer and single employer plan coverage on a combined basis.

Nevertheless, many employers provide substantial and valuable health coverage to nonhighly compensated employees under multiemployer plans. It seems inequitable to permit employers who provide valuable health coverage to their salaried nonhighly compensated employees in a nonbargained situation to take credit for that coverage when testing the coverage they provide to their highly compensated employees, but to deny employers who provide coverage to their nonhighly compensated employees through the collective bargaining process the same opportunity.

In many, if not most, cases, this opportunity would not be available, as a practical matter, to employers contributing to multiemployer plans, simply because the burden of combined testing is too great. However, there may be some employers that would find combined testing, using the multiemployer plan valuation rules described above, reasonably workable, and that need to count this coverage to help their other plans pass the nondiscrimination tests.

We, therefore support the position taken by other groups that such employers shall be permitted (but not required) to elect to test their collective bargaining unit employees and their other employees on a combined basis.

IV. QUALIFICATION REQUIREMENTS

We also urge you to consider exempting multiemployer plans from the qualification requirements of Code section 89(k). In addition to ERISA, which provides most of the same participant protections as section 89(k), all multiemployer plans must meet comparable standards under section 302(c)(5) of the Taft-Hartley Act.

These plans are required under the Taft-Hartley Act to be in writing. In addition, under Taft-Hartley, there are protections to prevent the diversion of funds to purposes other than the benefit of employees. These plans, by definition, are maintained pursuant to collective bargaining agreements, which are legally enforceable, and employees may sue to enforce their Taft-Hartley protections directly. The minuscule percentage of employees covered under multiemployer plans who are not covered pursuant to collective bargaining agreements are covered pursuant to participation agreements, which are also legally enforceable. Collective bargaining agreements typically run at least three and often more years. Thus, the plans to which contributions are made pursuant to such agreements will be in effect for at least the one year required to satisfy the permanence requirement of section 89(k). Finally, these plans are subject to Title 1 of ERISA, which requires summary plan descriptions and other types of notice to participants. The unions, which bargain these plans, are also anxious to make certain that the employees are aware of the benefits that have been bargained.

The protections described above likely will not fit exactly all of the technical requirements of Code section 89(k). However, taken together and added to ERISA, they provide several layers of similar and adequate protections. It is therefore not necessary to impose on multiemployer plans and the employers contributing to such plans the burdens of compliance with Code section 89(k).

We therefore urge you to exempt multiemployer plans from the qualification requirements. These requirements are largely redundant in the context of multiemployer plans, which are subject to several other laws designed to achieve a similar purpose. In addition, because of the unique nature of multiemployer plans, the rules would be unworkable and would create inequitable and unnecessary burdens.

If you have any questions, or if we can be of further assistance, please call Vivian H. Berzinski (872-8610) of our professional staff.

Statement of the New York State Department of Civil Service

(Submitted by Walter D. Broadnax, Commissioner)

The New York State Department of Civil Service is the agency which has been designated by Governor Mario Cuomo to lead the State's Section 89 compliance activity. We want to make two major recommendations regarding Section 89: that the current statute be simplified; and that Congress rethink the appropriateness of applying laws of this type to public sector benefit programs in general, and especially to those of New York State.

To assist in the State's compliance effort, we organized an inter-agency steering committee, comprising representatives from the Governor's Office of Employee Relations, the State's Retirement System, the Comptroller's Office, and the Division of the Budget. The Committee members have a high level of expertise both in benefits administration and in compliance with legislative mandates. We sought guidance from several independent consultants. Despite this array of expertise, we find that we are still far from a clear understanding of many of the activities and issues we must address in order to fully comply with Section 89's current requirements. Even with respect to those activities we have agreed are required by the statute, we find that we are unsure that they can be accomplished in time to meet all the compliance deadlines of the current law even as recently extended. The one thing that is clear, however, is that the application of mandates such as the nondiscrimination tests of Section 89 to the benefit programs maintained within the public sector of New York State seems unnecessary to the achievement of its stated objectives, and excessively burdensome to the State's taxpayers, whose very interests the law purports to protect.

New York, as an employer, does not object in principle to the underlying premise of Section 89. Clearly, the use by employers of tax-exempt benefit plans to provide benefits which discriminate in favor of highly compensated employees is a public policy issue that must be addressed. In this respect, Section 89 holds forth some laudable objectives. It is also part of an understood social policy agenda which is targeted at increasing the availability and access to a broader array of benefits for all workers in this nation. Again, this objective is both acceptable and laudable.

Our concern is the work load and cost impact of this statute and regulatory action by the Internal Revenue Service upon New York State and other public employers.

The public sector benefit plans in New York State which must be tested under this law have origins, design and ongoing oversight which are so different from private sector benefits administration that the inequities meant to be eliminated by Section 89 are consistently absent. The authority for our programs resides in public statute and regulation. Plans are developed through collective bargaining agreements, then subjected to legislative scrutiny and oversight prior to implementation under the laws of the State. Union representation throughout the public sector work force in New York is greater than 90%. Collective bargaining agreements and long-established administrative policy uniformly require full disclosure statements and plan descriptions similar to those mandated by the Section 89 qualification standards.

The concept of discrimination, wherein benefits are accorded to highly compensated employees on a different eligibility basis or contribution level than to nonhighly compensated employees is foreign to public sector plans; everyone from the Governor to the entry level clerical assistant is covered by the same eligibility requirements and contribution formulae. Therefore, to subject public sector employers' benefit plans to criteria and testing intended to identify benefit disparities among private sector employers, is an unnecessary and extremely expensive administrative exercise.

Furthermore, it is unclear how some of the terms and conditions in Section 89 language apply to the public sector. For example, the concept of "a line of business" has been understood by private employers as they work within the framework of rules, regulations, reporting requirements, etc., but it does not have any clear, generally accepted meaning in State government. Each New York State agency, such as the Department of Correctional Services, the Department of Health, the Department of Motor Vehicles, has a separate and distinct mission. Do we treat each State agency, with its separate mission, as a separate line of business? Must we then have separate qualifying plans and discrimination testing for State employees in each of these "separate lines of business?"

We are also concerned by the lack of clear definition of the term "employer" as it applies in the public sector. In addition to distinct executive operating agencies, there are three separate branches of State government. What criteria should be ap-

plied to establish the parameters of the State's "employer" status? These are but two examples of the kind of clarifying questions that the public sector needs addressed under Section 89.

Despite all of the preceding, New York State has begun the task of qualifying State benefit plans within the special context of Section 89. We support the qualification standards of Section 89 as worthwhile, as evidenced by the fact that they closely resemble many of our existing standards. But for an employer as large and complex as New York State, the task is formidable.

Health plans centrally administered by the Department of Civil Service currently cover some 320,000 employees and retirees of State government and more than 700,000 of their dependents. In addition to the health plans, of which there are 30 currently offered, we also administer various separate dental, vision, hearing and life insurance plans, all with different participant demographics. Once the data about the plans is merged, most of them can be qualified with reasonable effort through reference to, and incorporation of, existing documents.

In addition to these centrally administered plans, however, there are numerous other localized benefit plans available to State employees, and also many union benefit fund-administered plans, which are supported by employer monies allocated through collective bargaining. It is unclear to us which, if any, of these plans must be qualified and tested under Section 89. It is unclear whether, or why, we are responsible for the work, especially with regard to the union-administered benefit funds over which the State has no administrative control whatsoever. The Department-administered indemnity health insurance plan is also available on an optional basis to employees of local governments. Some 175,000 employees of about 900 separate local government employers are currently enrolled, but it is unclear what impact local administration of our plan might have on the State's compliance activities.

Although the State maintains detailed data about its benefits plans and much of this data can be used to meet the intent of the statute, to fully comply with exact Section 89 requirements, we must aggregate this data from disparate sources and from all of our employment sites, compile all plans in a different written format, and then test first for qualification and then for discrimination. These start-up tasks, including the ongoing maintenance of compliance documentation, are very substantial and will be costly for this government, as well as for the towns, villages and school districts, which, although participating in our health plan, must conduct separate testing specific to their own work forces.

By the first deadline under the statute, modified by IRS to October 1, 1989, New York must, as an employer, provide notice in accordance with the law to all of its employees of all qualified plans. The compilation of data and the production of the materials necessary to produce written notices which conform exactly to Section 89 specifications and distribute such notices to more than 300,000 employees is, in and of itself, an extremely costly effort. Besides being largely duplicative of existing notices, it may simply be impossible to achieve by October 1. Admittedly, the statute provides for a good faith effort, but this government does not wish to find itself in noncompliance with a federal statute, especially one with such onerous and far-reaching financial penalties for both the State and its employees.

Once beyond the qualification requirements, we believe the very technical nature of the nondiscrimination testing of the current law, coupled with the complexities of the regulations recently issued by the IRS, has virtually no applicability to public sector benefit plans in New York State.

We support current proposals to simplify the discrimination tests. But compliance with even these simplified requirements will necessitate expenditure of taxpayer monies by both State and local government entities to verify what is already implicit in the nature of our benefit plans since existing laws and government practice involving public employers and employees in New York State do not allow discrimination in favor of highly compensated employees.

The cost to compile a substantial amount of data, to develop entirely new communication channels to all of our employees, and to design complex new and ongoing reporting and data collections systems will not translate into improved benefits for State and local government employees, nor will it result in new revenue for the Federal government. Rather, it will substantially increase our administrative expenses which will result in ultimately producing higher premium costs to be paid by public employees and public employers, all of which translates into substantial new expenses for the taxpayers of New York State.

Unlike private business, we are not able to pass the cost of compliance on to a separate cohort called "customers." Our "customers" are also our employers, and yours—the taxpayers of this State and country.

Nor does New York State have the "avoidance" option afforded to the private sector by Section 89 which is to simply report benefits as taxable income. Private sector employers who choose this route typically increase overall compensation to employees to make good the extra tax burden which falls on them. In the public sector, "compensation" is established by collective bargaining and legislative action. We must protest Federal actions which could interfere with or influence this State prerogative.

To summarize, we offer three recommendations.

First, and emphatically, simplify the current discrimination testing requirements. The simplification tests of Representative Rostenkowski's April 13 Congressional bill seem eminently more reasonable and meaningful to achieving the stated goals of Section 89, although even that proposal has shortcomings which we have commented upon to the House Ways and Means Committee.

Second, extend the compliance deadlines to give IRS a chance to provide meaningful guidance, especially to the public sector, and to give employees the opportunity to achieve meaningful compliance.

Third, exempt public sector employers such as New York State from Section 89, and from future legislation dealing with employee benefits, because we do not receive any tax advantages from providing employee benefits, and because we already have elaborate mechanisms to prevent the creation of discriminatory benefit plans.

Thank you for your thoughtful consideration of this matter. We are available to assist you in any way we can to better understand the problems this legislation creates for New York State and other public employers within our jurisdiction. You can truly assist us by taking appropriate congressional action.

POTOMAC ELECTRIC POWER COMPANY

Washington, DC., May 31, 1989.

Senator LLOYD BENTSEN,
Chairman, Senate Finance Committee,
U.S. Senate,
Washington, DC.

Re: Proposed Legislation to Simplify Section 89

Dear Mr. Chairman: Potomac Electric Power Company (Pepco) provides retail electric service to 1.8 million people in a 640 square-mile service territory in the Washington, D.C. metropolitan area, including the District of Columbia and major portions of Montgomery and Prince Georges's counties in Maryland. As a provider of health and welfare benefits to over 5,400 employees, we are very interested in the Senate Finance Committee's current efforts to make the Section 89 nondiscrimination rules more efficient and workable. In this regard, we respectfully submit the following comments relating to proposed Section 89 legislation.

TESTS SHOULD BE BASED ON AVAILABILITY

The fundamental intent of Section 89 was to ensure consistent and fair availability of health and welfare benefits to all employees. Pepco, like most electric utility companies, complies with this intent by making its health programs available to all employees on an equitable and affordable basis. While the freedom of choice inherent in such plans precludes discrimination, it also eliminates the employer's ability to control benefits utilized by either highly compensated or rank-and-file employees. Thus, such a plan could conceivably fail a utilization-based discrimination test. We, therefore, strongly recommend that the Section 89 nondiscrimination tests be based on the availability of benefits to employees rather than on the benefits actually utilized by employees since the latter test may not fairly determine discrimination in situations where all benefits are available to all employees.

LEASED EMPLOYEES SHOULD BE TESTED AT THE LEASING ORGANIZATION LEVEL

The current Section 89 requirement that recipient organizations include leased employees in their nondiscrimination testing requires the collection of considerable data on such employees which is not currently available and creates an onerous administrative burden. In situations where the leasing organization provides bona fide benefits to the employee, these requirements are unnecessary to achieve the goal of the nondiscrimination provisions. We recommend that leased employees be excluded from the recipient organization's testing if such leased employees are offered affordable core health care benefits by the leasing organization. Accordingly, nondiscrim-

ination testing of such benefits should occur at the leasing organization level based upon the health and welfare benefits available at such entity.

The Section 89 Simplification Act, H.R. 1864, currently under consideration in the U.S. House of Representatives provides a safe harbor with respect to certain leased employees if such employees do not make up 20% of the employer's workforce. Should the Senate adopt similar provisions, we strongly recommend that the 20% restriction be eliminated and that such legislation provide a reasonable period of transition to allow employers an adequate period of time to modify existing contractual arrangements. The elements of such transition period would include, in our view, the following:

(1) An overall moratorium on the application of the leased employee rules to Section 89 for the year 1989.

(2) The application of the leased employee rules to Section 89 for the year 1990 based upon the availability of a core health plan, whether or not such plan meets any qualification rules for maximum employee contributions.

(3) New leased employee rules would be fully effective in year 1991.

DEPENDENT CARE ASSISTANCE PROGRAMS

Current law allows Dependent Care Assistance Programs to be tested under either the nondiscrimination rules of § 89 or § 129. The present § 129 average benefits test is based on benefits actually received by employees and may not fairly determine nondiscrimination where plans are available to all or a large portion of company employees. This is especially true where the employee population consists of older or younger employees who do not have dependents and thus do not participate in the program. For these plans, nondiscrimination is better determined under a § 89 test based on availability. For this reason we strongly recommend that any proposed legislation to simplify Section 89 include a Dependent Care Assistance Program nondiscrimination test based on availability and that employers be allowed to choose to test such programs under either Section 89 or Section 129 as allowed under current law.

BARGAINING UNIT PLANS

H.R. 1864, the proposed legislation currently under consideration in the U.S. House of Representatives, requires bargaining unit employees to be tested separately under Section 89. Should the Senate adopt similar legislation, we request that this provision be altered so that employers may elect to test bargaining unit plans separately. This election is needed because separate testing may not fairly determine nondiscrimination in situations where the same health care plan is available to both bargaining unit and non-bargaining unit employees. Considering the requirements to include leased employees in nondiscrimination testing, the importance of this election cannot be under-emphasized. We strongly believe the intent of Section 89 would be better served if any provision to require separate testing of bargaining unit employees be made elective on behalf of the employer. Such election could be a one-time, irrevocable election if necessary.

SALARY REDUCTION AMOUNTS TREATED AS EMPLOYEE CONTRIBUTIONS

H.R. 1864, the proposed legislation currently under consideration in the House of Representatives, contains a benefits test which is designed to ensure that highly-compensated employees do not receive a disproportionately higher level of employer-provided benefits than rank-and file employees. For purposes of this test, salary reductions made by highly-compensated individuals under a cafeteria plan are to be treated as employer contributions. Should the Senate adopt similar legislation, we recommend that the proposed benefits test be modified so that salary reductions are treated as employee contributions for both highly compensated and non-highly compensated employees. To treat these amounts as employer-provided benefits only for highly-compensated employees is simply inequitable and distorts the amount of actual employer-provided benefit provided to all employees. We believe equal treatment of all employees for purposes of this test is fair and appropriate.

INDEXING OF MAXIMUM EMPLOYEE CONTRIBUTIONS

H.R. 1864, the proposed legislation currently under consideration in the U.S. House of Representatives, would index maximum employee contributions to the cost of health premiums to changes in the average wage index. Should the Senate adopt similar legislation, we recommend that the index be based on medical costs rather than average wages. A medical cost index would be a more appropriate index be-

cause premium costs are linked to changes in health care costs which are traditionally significantly higher than changes in average wages. The use of the wages index would gradually decrease the employers ability to share the cost of health benefits with employees. As a result, health programs will become too costly to be maintained by many employers. To avoid this problem, we recommend that maximum employee contributions be indexed to changes in health care costs.

Pepco sincerely appreciates this opportunity to present our views on these complex and important Section 89 issues. Your consideration of our concerns and our recommendations is appreciated.

Yours truly,

DENNIS R. WRAASE.

SERCO INC.

January 31, 1989.

Hon. PETE DOMENICI,
U.S. Senate,
Washington, DC.

In regard to the IRS Section 89 rules, I have spent two days trying to understand the requirements and comply with this new rule. At this point I can only ask for your help in eliminating this additional burden. Small business owners are already inundated with countless Government forms and paperwork. In the operation of two small businesses employing approximately 100 people I currently spend 2 days per week average in complying with "COBRA," "ERISA," "IRS" and many other State and Federal rules. Now comes "Section 89". If this burden cannot be repealed then please help me to understand and comply. I do not understand how to even begin. I have a small Guard Contract at White Sands Missile Range with approximately 84 personnel. There are two owners who would be included in "HCE". This work force is covered with a Collective Bargaining Agreement. Only full time personnel are covered for health benefits which the company pays 100%. Full time personnel dependent coverage is co-insured 80% paid by company and 20% paid by employee. There are 55 full time employees currently on the payroll. Part-time personnel can participate if they pay for the coverage themselves and their dependents. The part-time work force presently numbers 20.

Full-time and part-time categories are as defined in the Collective Bargaining Agreement.

There are in addition to the above, nine supervisory personnel for which the company pays both the employee and dependent coverage 100%.

The same percentages and number of personnel apply to the Dental Plan, Vision Plan, and Group life insurance.

To help you help me; I've provided you with a copy of the Section 89 Rules.

The second business is a retail furniture store which employees 15 to 20 personnel. I have had a health plan for these employees for the last six years. With Section 89 I feel it would be much simpler to cancel the health plan. This would also save $2,000 per month. It is also impossible to comply with Section 89 in the absence of regulations.

As described in attachment this new law can only be described as outrageous, costly, complex, confusing, and counterproductive. It is time for all law makers to realize that small employers must have help. Everyone must remember that before the employee can get paid, or have paid benefits, the employer must have the money.

Please, please help us.

JERRY L. FAMBROUGH, *President.*

STATEMENT

OF

SHEET METAL AND AIR CONDITIONING CONTRACTORS'

NATIONAL ASSOCIATION, INC.

(SMACNA)

HR 1864

The initial version of Section 89, and recent regulations published by the IRS, are clearly unworkable and unrealistic when applied to construction industry setting.

Although the stated purpose of HR1864 is to simplify the anti-discrimination rules applicable to certain employee benefit plans, it does not recognize, as it should, circumstances where there is no evidence of so-called discrimination. If Congress is interested or concerned with discriminatory benefit plans which are typically implemented in major corporate settings, and in certain areas such as health, law, engineering, architecture, accounting, actuarial science, financial services or consulting, then Section 89 legislation and associated regulations should be specific to firm size or the area of operation.

With specific reference to provisions of HR1864, SMACNA offers the following comments:

- Aggregation of Plans [Section 89(b)(2)(C)]

  In this section there is a requirement that employers 'may elect to treat any group of 2 or more health plans as 1 plan if - (i) each of such plans is available to the same group of employees with the same eligibility requirements....' In circumstances where employer maintain one plan through a collectively bargained agreement and another for employees not represented under the terms of the agreement, it is virtually impossible for non-represented employees to be eligible for coverage under the multi-employer health benefit plans. In such circumstances, aggregation of plans is not available to SMACNA members, or for that matter any union construction contractor.

- Requirements - In General [Section 89(C)(1)]

  The 90% eligibility test should be changed to a 70% test which is consistent with pension coverage rules.

- Qualified Core Health Plan [Section 89(C)(2)]

  SMACNA also believes that the initial level of $10 to $25, and in fact any level established in federal legislation will tend to undermine cost containment programs where employees are asked to assume a portion of increased health care cost (if for no other reason than to ensure that employees monitor health care charges or fees).

- Cost of Living Adjustment [Section 89(C)(B)(A)]

  SMACNA believes that the use of an average wage index is inappropriate and that the most appropriate index is one that has relationship to health care costs which in recent years have been double digit with no sign of abatement.

- Special Rule for Multi-Employer Plans [Section 89(e)(3)(D)]

  The special rule for multi-employer plans is meaningless unless the provision on treatment of union employees applies only to single employer bargaining units. Multi-employer plans by definition cover union employees.

- Treatment of Union Employees [Section 89(e)(8)]

  SMACNA believes that HR1864 represents a step backward with the provision to prohibit employer use of plans established for union employees. This new prohibition is unrealistic and unwarranted. Adaptation or modification of plan design and benefit levels to comply with Section 89 requirements is dependent on plan control and SMACNA members as well as other union construction industry employers, will be denied the right to adapt or modify because they are sponsors and contributors to health care plans established for union employees. As noted earlier in this statement, only plan trustees control plan design and benefit levels.

In addition and unless Congress intended to impose additional taxes on union employees, HR1864 should be modified to designate multi-employer plans covering union employees to be non-highly compensated plans. If Congress fails to make this change skilled union workers in a supervisory positions may be subject to increased income tax burdens for so-called discriminatory benefits.

Based upon SMACNA's research of negotiated wage, health and welfare contribution levels (attached), it is evident that certain union sheet metal workers, onsite construction employees, are or soon may be subject to additional income tax under the provisions of HR1864 when coupled with the definition of highly compensated employees.

SMAC' finds it difficult to believe that additional taxation of construction wor' rs is consistent with the interest of Section 89. Such additional taxation does, however, conform with those who maintain that Section 89 represents a hidden agenda, namely the first step toward taxation of fringe benefits as a way to generate alleged tax revenues of $32 billion.

As a matter for additional research, SMACNA recommends that Congress assess the impact of Section 89 on union electricians, pipefitters, and plumbers, especially those working in high cost of living/wage areas.

In this section, there are also provisions regarding the definition of a "qualified bargaining unit". Neither HR1864 nor the Secretary of Treasury should seek to redefine what a "qualified bargaining unit" is, since existing labor law and federal agencies have already established such criteria.

SMACNA is a national trade association representing over 5,000 contributing contractors employing well over 100,000 union sheet metal workers. SMACNA members specialize in the fields of heating, air conditioning, air pollution control, solar energy installation, architectural sheet metal and other metal applications.

HEALTH BENEFITS IN CONSTRUCTION

SMACNA members contribute on a per hour basis to multi-employer health benefit plans established under the terms of collectively bargained labor agreements. Under those agreements, employers contribute to a pooled-fund on behalf of the work force.

Multi-employer funds are jointly trusteed by equal number of representatives from labor and management, with trustees retaining control over health benefit plan design and benefit levels.

SMACNA members are aware of only the level of contribution for health benefits as agreed to in the collectively bargained agreement.

Additionally, SMACNA member firms also maintain "in-house" single or group employer health benefit plans for supervisory or managerial employees not covered by labor agreements.

SECTION 89 AND CONSTRUCTION INDUSTRY HEALTH BENEFITS

The stated purpose of Section 89 legislation and subsequent regulations is to make health care benefits available on a nondiscriminatory basis to the maximum number of employees.

SMACNA members contribute on the average of almost $2 per hour for employee health benefits. That $2 equates to an average of almost $3,500 on a yearly basis and that amount provides excellent health care benefits to the more than 100,000 union sheet metal workers employed by SMACNA members.

Based on information available to SMACNA regarding health benefit plans for non-represented employees, it is evident that coverage is similar if not the same as the coverage provided under the multi-employer plans.

Industries or sectors within an industry with such a factual situation should be excluded from coverage under Section 89. At a minimum, an industry or sector should be given the opportunity to petition for an exemption from Section 89 requirements.

Recognizing that superior health care benefit programs are provided to 99.9% of SMACNA member union and non-represented employees, there is an acceptable and a justifiable argument that owners and officers, those who risk their net worth with every construction project bid, are entitled to additional benefits. These small business firms have established liberal health care coverage for employees, and owners or officers should not be penalized for assuming the risks of doing business.

It is that very concept of rewards or incentives that formed the foundation for the economic system under which this economy exists. Unfortunately, rewards or incentives are now being described as 'discriminatory' unless the additional benefit for risk-taking is available to those already covered by health care benefits. That description under the circumstances is unwarranted.

CONCLUSION

SMACNA is encouraged by the willingness of Congress to revisit this issue and urges either repeal of Section 89 or significant modifications to simplify Section 89's implementation, including an exemption where the vast majority of the employer's work force is covered by one or more multi-employer benefit plans providing health care benefits which otherwise meet other provisions of the eligibility test proposed in HR1864.

ANNUAL INCOME[1] AND HEALTH AND WELFARE CONTRIBUTIONS

INCOME[2]	HW	CITY
56060.000	4800.000	Oakland
50140.000	4800.000	San Jose
48300.000	5660.000	Los Angeles
45660.000	3874.000	New York
45340.000	4400.000	Boston
45020.000	4380.000	Las Vegas
43900.000	2700.000	Seattle
43480.000	4800.000	Sacramento
42480.000	5340.000	Philadelphia
42140.000	3800.000	Cleveland
42000.000	5020.000	Norwalk
41960.000	5100.000	San Diego
41860.000	5100.000	Santa Barbara
41480.000	3660.000	Honolulu
41000.000	3300.000	Trenton
40500.000	2860.000	Aurora
40320.000	2860.000	Joliet
40040.000	5200.000	Hartford
39800.000	4380.000	Chicago
39480.000	4840.000	Wilmington
38800.000	4000.000	Elizabeth
38800.000	4000.000	Newark
38728.000	5658.000	Detroit
37880.000	3000.000	Toledo
37620.000	3500.000	E. St. Louis
37420.000	2900.000	Providence
37400.000	4300.000	Stockton
37260.000	2300.000	Tacoma
37180.000	3000.000	Rockford
36900.000	3400.000	Gary
36820.000	3400.000	Evansville
36640.000	2870.000	Syracuse
36560.000	3400.000	Indianapolis
36260.000	3400.000	Madison
36160.000	3700.000	Terre Haute
36080.000	3400.000	Lafayette
36000.000	2400.000	Buffalo
35920.000	4390.000	Albany
35920.000	4100.000	Rochester
35840.000	2400.000	Ottawa
35800.000	2660.000	Portland
35660.000	2400.000	Pocatello
35360.000	3400.000	South Bend
35320.000	3400.000	Ft. Wayne
35140.000	5080.000	Pittsburgh
34980.000	3980.000	Milwaukee
34920.000	5580.000	Reno
34720.000	3560.000	Janesville
34420.000	2900.000	Parkersburg
34280.000	3440.000	Rochester

[1]Does not include vacation pay, savings plan contributions or overtime pay.
[2]Based on 2,000 hours of work.

Source: Construction Labor Research Council 5/26/8

Statement of Simpson Investment Company

(Submitted by Joseph L. Leitzinger, Vice President, Public Affairs)

Simpson Investment Company is the holding company for Simpson Paper Company, Simpson Timber Company and Pacific Western Extruded Plastics Company. We manufacture pulp and paper products, lumber, plywood, doors, and extruded PVC plastic pipe in California, Michigan, Ohio, Oregon, Pennsylvania, Texas, and Washington States.

BACKGROUND

Simpson has 8,000 U.S. employees. All employees who are hired for regular jobs (i.e., will work 90 days or more) have medical and life coverage. Benefit costs represent a higher percentage of pay for lower-paid employees than for higher-paid employees because of the cost of our medical plan (an average of $2,800 per year for 1988–89). We have 5,500 employees who are covered by collective bargaining agreements with seven different unions. Medical plans and other benefits vary by union and by location. We have 26 medical plans, numerous HMO's and 2,100 employees who are covered by multi-employer health and welfare trusts. Simpson has 29 work locations. Employees are paid out of one of three payroll systems. We have no common employee data base with Information on all employees. Simpson does not collect all the data required to run the Section 89 test, i.e., scheduled hours of work each week, marital status, whether the employee has coverage under a spouse's medical plan, whether an employee has eligible dependents, employee relations data on independent contractors ("Kelly Services," contract janitorial workers, security guards, etc.). Costs to collect and maintain this data would be high and have no value for other purposes.

To date, Simpson has spent $50,000 in outside consulting fees, plus hours of internal staff time trying to understand the regulations and identify the data necessary to comply with them. In 1989, we expect to incur $80,000 in consulting costs to run the test, and $40,000 each year thereafter. This does not include internal computer time, nor staff resources.

A rough cut of our compliance with the test based on the data we collect on our existing data systems, and on the proposed regulations, indicates that Simpson will pass the test for medical plans. We appear to fall it on the life insurance plans because collectively bargained employee groups have lower life insurance benefits than do our non-union employees. The non-union plan is based on competitive comparisons. The collectively bargained plans reflect the union desires to spend compensation dollars in medical and other areas. If we fall the test on the life insurance benefit, which requires additional taxable income to be imputed to highly-paid employees, it will generate very little added tax revenue since the value of life insurance over $50,000 is already subject to taxation under current IRS regulations (Section 79).

CONCLUSIONS

There are easier ways than Section 89 of assuring that employers provide equitable benefits to all employees. A continuation of tax-favored treatment of company expenses to fund benefits is a strong incentive, as are competitive pressures as employers seek to hire from a shrinking labor pool. Section 89 regulations require such a complex computer system that small businesses will in fact be discouraged from providing benefit plans to employees because of their inability to comply with this regulation.

Expending resources in the form of money and time to install data systems which add expense, but not value, to a company's product or service, make the U.S. less competitive internationally, and this is exactly what these regulations require.

ANALYSIS OF LEGISLATION TO SIMPLIFY SECTION 89 AND H.R. 1864

Section 89 is an important issue for Simpson. It places significant cost burdens on employees to understand the regulations and to identify the data necessary to comply with them, does not provide benefits to employees, and in our case generates little added tax revenue.

We have commented to Members of Congress before on Section 89 that the following actions should be taken, in order of priority:

1. Repeal the act in its entirety.
2. If repeal is not possible, at least adopt the following changes:

a. Have the IRS work with a group of employers to simplify the regulations so they are compatible with data systems that employers typically have.

b. Exclude collectively bargained groups from the law as their benefits are governed under the National Labor Relations Act, and cannot be unilaterally controlled by the employer.

3. If neither of the above is possible, delay implementation of Section 89 until final regulations are published and employers have time to understand them and set up data systems to comply with them.

We have been encouraged that the complications of Section 89 have been realized, and that HR 1864 has been introduced to simplify some of the compliance requirements.

We are pleased by the following effects of HR 1864:

1. Simplifying the eligibility test; although an 80% testing factor would have been preferred to the resolution's 90% level, Simpson should pass at 90%,

2. Returning group life insurance from Section 89 to Section 79 tax treatment,

3. Redefining part-time employees as those who work 25 or more hours per week (Simpson provides coverage at 20 hours per week), and

4. Measuring plans of collectively bargained groups separately. (We are assuming the proposed law would test each bargaining unit separately. This is important given varied benefit packages negotiated on a unit by unit basis to meet local needs.)

We are very concerned about the following as affected by HR 1864:

1. The price of the health care options in a cafeteria plan, rather than the net difference between company provided funding and the price, is used in the Eligibility Test and Benefits Test,

2. Cafeteria benefit plans, salary reduction premium arrangements and medical reimbursement accounts are unfairly attacked by the proposed 133% Benefits Test,

3. The $10 per week individual and $25 per week family premium caps do not reflect geographic or plan design differences,

4. The indexed premium caps won't track with changes In the cost of medical coverage,

5. The application of the rules to prior employees (retirees) is unmanageable, and

6. The revised provision on "leased employees" in the test will still be difficult to satisfy based on limited information about these nonemployees.

Here is how these areas of concern affect Simpson employees, and our suggested remedies:

CAFETERIA BENEFITS PROGRAM TREATMENT

All of Simpson's 2,500 nonunion employees, whether hourly or salaried are eligible for the same benefits options under the company's cafeteria benefits program. This program includes at least three medical coverage options at each of our 29 work locations and an additional one or two health maintenance organization (HMO) options where they are available. Simpson provides each employee, by line of business, with the same amount of health care benefit dollars to spend on his or her choice of a family health care option. Any residual dollars may be taken as taxable compensation or grouped with other company-provided or salary reduction dollars to buy other benefits, such as: employee and dependent life insurance, short-term and long-term disability coverage, health care and dependent care reimbursement accounts or additional vacation.

On the face of it, Simpson's plan should easily satisfy the Eligibility Test. It appears, however, that the test will focus on the total price of the health care options within the flex plan rather than on the employee's cost after applying the company-provided benefit dollars to purchase "core medical coverage" (i.e., the *net cost*).

We suggest that for cafeteria benefit plans the measure should be whether the employer-provided medical funding, plus any added employee premium, is adequate to purchase "core medical coverage" within the limits of the law. Further, since the total cost of the coverage in a cafeteria plan is paid by salary reduction, that only the *net cost* of core coverage be considered for compliance with the $10 and $25 employee premium limits of Eligibility Test. This *net cost* approach most closely measures the true cost to the employee for coverage.

BENEFITS TEST

The 133% Benefits Test is flawed by the unequal treatment of salary reduction amounts for highly compensated v.s. all other employees. As we understand the proposed test, only the highly compensated employees would have salary reduction amounts included in valuing coverage. This would be compared with the cost of medical coverage alone for all other employees.

We suggest the salary reduction amounts of all employees, not just the highly compensated, be included so the Benefits Test taxes highly compensated employees only if they use the salary reduction option to a greater extent than all other employees.

As described above, Simpson is providing all employees with the same amount of benefit dollars to spend on family health care coverage. It is sufficient to purchase "core health coverage" plus dental coverage. But, the Benefits Test as currently written creates bias against cafeteria benefits programs, salary reduction arrangements and medical care reimbursement accounts. This could be corrected if our suggestion is adopted.

EMPLOYEE-PAID PREMIUM CAPS

We understand the objective of the employee-paid premium caps is to assure the availability of affordable health care. However, the long-term result of the $10 individual and $25 family caps being indexed to wage growth rather than medical coverage cost may be to reduce the levels of coverage provided. Health care cost increases have consistently been much greater than wage growth or increases in the CPI.

Simpson's cafeteria plan health care premium cost increased 22% in 1988 and 42% in 1989 while wages advanced about 4.5% each year. If the employee cost of coverage were to approach the HR 1864 limits, or if the aggregate cost of coverage gets too high, Simpson would have to consider reducing the coverage available in order to be able to continue to offer health care to its employees.

The premium caps also fail to recognize potential plan design or geographic differences in the cost of coverage.

We suggest that any caps retained in H.R. 1864 be expressed as a percent of premium cost, such as 33% of the cost of individual coverage and 50% of the cost of family coverage. This allows recognition of geographic medical cost differences, avoids excessive cost shift to employers and reduces the risk of mass plan design changes.

FORMER EMPLOYEES

Applying Section 89 to retirees and other former employees is unmanageable. Simpson offers health care coverage to its nonbargaining unit retirees. About 475 are enrolled and many cover their spouses. Their retirement dates range from the early 1960's to the present. There were no highly compensated employee definitions when most of them retired. Many retired before ERISA. Neither Simpson nor its consultants have determined how the Section 89 rules can be meaningfully extended to that group.

We suggest such rules be eliminated from the proposal, or at a minimum, delayed until the first day of the plan year following the issuance of *final* regulations for former employees, and then be applicable only to people retiring on or after the effective date.

LEASED EMPLOYEES

We appreciate the relaxation of the leased employee rules in H.R. 1864, but feel they don't go quite far enough.

Simpson does not hire "leased employees" from another organization to avoid benefit plan costs. We occasionally contract with independent logging firms, or wood chip haulers, and security guard or janitorial service companies for specific services, but we do not "lease" employees for our regular business operations.

We suggest that if "leased employee" represent less than 20% of the workforce they be excluded entirely from the tests. We do not now gather the information on "leased employees" required to conduct these tests. Obtaining statements from "leasing organizations" certifying "core medical coverage in compliance with H.R. 1864" would be burdensome.

We appreciate very much the opportunity to have this testimony entered into the record for the May 9 Committee Hearings. Also, the Committee's efforts to simplify the Section 89 regulations are gratefully acknowledged. Simpson would be pleased

to provide any further assistance and/or support to the Senate Finance Committee in these efforts.

Statement of the Small Business Council of America

(Submitted by Paula A. Calimafde)

Mr. Chairman and Members of the Committee, my name is Paula A. Calimafde, and I am entering this statement into the record on behalf of the Small Business Council of America (SBCA), a nonprofit, nonpartisan national organization which represents the interests of small business organizations on Federal tax and employee benefit matters. The Small Business Council of America is a member of the Small Business Legislative Council, a coalition of nearly one hundred trade and professional associations representing the interest of over four million small businesses.

The subject of these hearings, Section 89 and the proposed modifying legislation, is of major concern to small business owners and the outcome of your findings and whatever corrective measures you undertake, be they outright repeal or major simplification of this extremely complex and unwieldy statute, will significantly impact every small business owner who now provides or may be considering providing health coverage to his or her employees.

The Small Business Council of America applauds the efforts of those members of Congress, most notably, Senator Pryor, Senator Domenici, and on the House side, Congressman LaFalce and Congressman Rostenkowski, Chairman of the House Ways and Means Committee, for introducing legislation that would repeal or modify Section 89. Hopefully, these hearings and the corresponding hearings held earlier in the month by the House Ways and Means Committee will help you to better understand the difficulties faced by employers in trying to comply with the present law and will provide you with alternatives which will help Congress to realize its objectives without unduly burdening employers with additional paperwork and regulations.

The Small Business Council of America, an organization composed of small business owners and leading tax experts from all over the country, endorses the statements set forth in the testimony submitted by the Small Business Administration which address the misconception that small employers tend to discriminate in the provision of health benefits. As the Small Business Administration has shown, if a small business does offer health coverage, it more frequently offers such coverage to all of its workers than do large firms event though doing so places a much larger cost burden or small employers. Not only does small business pay more for health insurance coverage as compared to large business, but its costs of compliance with Section 89 and the proposed regulations are far greater. It would be a grave injury to the employers of small business if they are forced to discontinue providing group health care because the cost of complying with this new law is simply too high.

We have been told that one of the problems facing Congress in its attempts to make changes which will simplify this legislation is that such changes must not affect substantially the revenue estimates that are based on current law. However, one IRS spokesperson speaking at the recent American Bar Association Tax Section Conference in Washington, D.C., stated that the revenue estimates did not take into consideration the numerous hours of professional time required from lawyers, accountants, consultants and other benefits professionals to determine whether or not an employer's plans pass or fail the discrimination tests. This time costs money, in professional fees or salaries of persons hired who must administer the tests. In addition, there is the expense of meeting the qualification requirements, in preparing the notices and written plan documents that will satisfy the regulations. These fees and salaries are expenses which are deductible from an employer's income tax. If the experience of the members of the Small Business Council is representative of the general population, it is likely that the revenue loss from these added deductible expenses cut in deeply to any projected revenue enhancement. As one small business employer complained, he had spent $3,000 on discrimination testing only to find that he was in compliance. And his costs to date did not take into consideration the costs of complying with the qualification requirements.

We are not suggesting that the goals of broad based and nondiscriminatory health care coverage which Congress has attempted to achieve in Section 89 are not laudable. We are, however, suggesting that there has to be a way to achieve this goal which will not require employers to undertake the mountains of paperwork, the countless hours of testing or data collection, or the prohibitive costs of hiring bene-

fits professionals to perform the tests, particularly when there is evidence to suggest that the rampant discrimination feared by some just does not exist.

Thus, we have prepared this statement for the record to offer suggestions for areas which we believe must be addressed in any modifying legislation. In addition, we endorse the positions of the Small Business Legislative Counsel, the U.S. Chamber of Commerce, and the Small Business Administration which were set forth in testimony presented to this Committee.

The Small Business Committee of America strongly supports the inclusion of the following points in any legislation on Section 89. We believe these points merit serious consideration in order to alleviate the worst administrative problems and inequities faced by small businesses when dealing with Section 89:

- We support the move towards design based testing that is proposed in several of the bills before Congress. Design based testing will go a long way towards relieving the administrative burden in complying with Section 89 by allowing an employer to look at the plan itself rather than employee demographics to determine whether there is a discrimination problem.
- The availability test of a health care plan must be fair to a very small company—for instance, a company with 5 employees must offer health insurance to all 5 to pass a 90% test—a small company should be required to have insurance available to a majority of the non-highly compensated employees (and only those that are insurable) rather than be subject to a very high percentage test which operates unfairly in the context of a very small company. At the very minimum, the 90% test should only be applied to employees who are *insurable.* It is not unusual for an insurance carrier to pick and choose which employees employed by a small business it will insure. In the example above, if an insurance company refuses to insure one employee because he or she is deemed to be an unacceptable high risk, then the small business will flunk the 90% test through no fault of its own and even though the company is offering insurance to everyone who is insurable. A test which requires coverage of no more than 70% of an employer's non-highly compensated employees, or which requires coverage of a fair cross-section of both highly and non-highly compensated employees would be more equitable. It is difficult to see the discrimination in an employer's covering no more than 50% of its highly compensated employees and 50% of its non-highly compensated employees. Congress should also give serious consideration to an exception for very small businesses in the form of an exemption from the requirements of Section 89 for all employers with fewer than 50 employees. We believe that such employers are least able to absorb the added cost that compliance with this law imposes.
- Any employee contribution limit should be based on a percentage of health care cost rather than a set dollar limitation. Rapidly escalating health care costs are one of the largest employee benefit expenditures faced by employers. The U.S. Small Business Administration estimates that the health care costs for small business range between 10 to 40 percent higher than that of large business. Also health care costs vary widely depending upon factors outside the company's control. These factors include such items as geographical location, age of employees, risk of business and size of business. The insurance premium for single coverage in Oxford, Maryland will be significantly lower than a similarly situated company in New York City. With as dollar limit, similarly situated companies will absorb substantially different costs based on factors beyond their control. Use of percentages will create far greater equity amongst all businesses, but small businesses in particular. And such costs rise at a much greater rate than the CPI. Unless an employer has a mechanism by which it can share those costs if they become too burdensome, it is conceivable that many employers may not be able to afford to provide this benefit for many more years. We would recommend a maximum cost payable by the employee of 40%, with 60% being provided by the employer.
- If modifying legislation adopts a dollar limitation on acceptable employee costs rather than utilizing the preferred percentage method, then the required employee contributions should be increased to take into account the business reality faced by small business: extraordinarily high health care costs. Such dollar limitations should be set at a level which does not place undue burdens on small employers. A dollar limit of $25 per week for family coverage is not workable for small employers. Moreover, any dollar limitation should be indexed not to wage growth, as provided for in Congressman Rostenkowski's bill, but rather, should be indexed to the rising medical care costs.
- Administrative costs and complexity should be kept to a minimum in order to keep our nation's small businesses competitive and viable. The concept of "snap shot testing" should be included in any final legislation. Employer provided benefits would be determined as of a designated date rather than being tracked throughout

the year. Small business is not able to "shop" its health care coverage so that the likelihood for abuse created by such a major simplification is remote. Snap shot testing would save countless dollars and time for small businesses. The importance of this issue simply cannot be overstated.

• The qualification rules appear to duplicate the rules set forth in Title I of ERISA and therefore seem to be a doubling up of requirements. Further, the 34% excise tax appears to be out of line with the other penalty provisions of the tax code. For instance, the penalty based on underpayment of tax due to negligence is subject to a penalty of only 5%. The Section 89 penalty for non-compliance with qualification rules should be no greater than 5%.

• The effective date of new Section 89 should be no earlier than 6 months after the Internal Revenue Service publishes regulations on the topic. If the effective date is prior to the release of regulations, then the regulations should only have prospective application.

The Small Business Council applauds Congress' attempt to recognize the problems faced by all business and small business in particular in their efforts to comply with Section 89. We are hopeful in the future that technical staff driven legislation will be reviewed carefully to assess its impact on small business and that a cost benefit analysis will be undertaken. Most importantly, the proposed legislation should be analyzed to ensure that the goals or intent of the legislation is implemented in the most cost effective way for small business. Small business is the engine powering our economy today, but it is not an indestructible one. Its strength lies in the entrepreneurial spirit of its owners, a spirit which can be crushed by the avalanche of laws, regulations and paperwork burdens being thrust upon small business by Congress—not to mention the stiff penalties lurking out there to be assessed against an unsuspecting employer for often de minimis failures to comply. On behalf of small business, we implore you not to slow down this engine needlessly by even one more overly complex and costly regulation.

STATEMENT OF

Small Business Legislative Council

We appreciate the opportunity to comment today on the subject of Internal Revenue Code Section 89.

The Small Business Legislative Council (SBLC) is a permanent, independent coalition of nearly one hundred trade and professional associations that share a common commitment to the future of small business. Our members represent the interests of over four million small businesses in manufacturing, retailing, distribution, professional and technical services, construction, transportation and agriculture. A list of our members is attached.

First, we must commend the Chairman and this Committee for recognizing the serious problem Section 89 has created for small business. This hearing is a positive start, and in our view signals much good faith upon which we may be able to build a solution to resolve this dilemma. We believe the nature and extent of the problems created by current Section 89 is apparent to almost all parties. We do not believe it is necessary for us to rehash those problems. Both the Senate and House Committees on Small Business have held hearings on the subject. The records of those proceedings have documented the harsh results Section 89 will produce if not repealed or revised. We would rather discuss the good faith efforts put forth by Senator Pryor and Representative Rostenkowski to seek resolution of this dilemma.

From our extensive discussions with small business owners throughout the nation, we come to the inescapable conclusion that we must be extremely careful to ensure any solution, which is not simply outright repeal, will meet the concerns of the small business community on the first go around. Section 89 has sent tremors deep and wide through the small business community. We understand the concerns of the proponents of the original Section 89 and while no small business owner would quarrel with the need to address the fundamental health care policy of this nation, we know small business will scrutinize any activity in Section 89 with the utmost care. We communicate their concern not as a sword, but to construct a framework for our comments on the process. While there are many similarities between Sen. Pryor's and Chairman Rostenkowski's proposal we have chosen H.R. 1864 as the reference point for our comments. This is simply an arbitrary decision and is no reflection of the relative merits of one over the other. We believe the concepts behind our remarks transcend the specific mechanics and apply to both proposals.

The most dramatic improvement accomplished by H.R. 1864 is to provide a high degree of certainty, and simplification, in the process by incorporating elements of a "design-based" solution. Replacing the several nondiscrimination tests with a single test is a significant improvement.

The key to any eligibility test is defining the pool of employees. It seems to us an eligibility test can be set around any number, 70 percent, 80 percent or 90 percent, and a compliance "cliff" will always exist. The impact of creating a "cliff" can be eased by addressing three issues. These fundamental problems are to determine what constitutes a full-time worker, dealing with the criteria for what constitutes extenuating circumstances which allow a small business owner to provide coverage to an individual, otherwise excludible, and perhaps most important to recognize factors, outside the control of the employer, that prohibit employee participation in a health plan.

There seems to be universal agreement that full-time workers are employed for at least 30 hours a week. Any standard of less than 30 hours will produce extraordinary harsh results. We fear that result will be a substantial increase in the cost of health insurance for all employees or the elimination of valuable part-time positions.

Second, in the universe of the smallest of small businesses with twenty or fewer employees, a 90 percent test can produce inadvertent, but harsh results.

For example, if a five-person firm is to meet the test, 4.5 workers would have to be covered and the only way such a small firm could comply, is to cover five out of five employees.

Third, the law should include a simple method for excluding those workers who, under any circumstances, would be ineligible for coverage. In most such circumstances, it is the insurance company that informs the small business owner a certain individual cannot be included under a plan.

As to the definition of highly compensated employees, if the issue is affordability, ownership is not necessarily an indicia of prosperity in a small business. As provided in the House proposal for officers, an accommodation should be made for *owners* not earning in excess of $45,000.

Any bill should include a clear, concise definition of core coverage.

We would hope the Committee would consider further simplification of the qualification rules. In particular, we would prefer a design-based standard. For example, the IRS regulations on what constitutes "legally enforceable" contemplate an ongoing, cumbersome evaluation. Certainty is important to a small business.

With regard to the benefits test, we believe the House bill sets unrealistic parameters. The bill compares the lowest premium of the nonhighly compensated employees to that of the highly compensated employees. We believe this is an extremely severe test that will produce harsh results.

The heart of H.R. 1864, in our opinion, is the requirement that an employer cannot ask an employee to contribute to health coverage in excess of certain, specified amounts. Putting aside for a moment whether this is an appropriate public policy, let us assume, hypothetically, that such a concept will be accepted by small business owners.

We believe the most likely result of implementation may be contrary to the stated objectives of the legislation, and will discourage small employers from providing health insurance. We believe this will be particularly true in the case of family coverage. The reason we believe this will happen, is that mandating a limit on the employee share creates a "cost cliff." Under pre-Section 89 law, an employer phased in health coverage, beginning, most likely, with employee-only coverage. As the company grew and profits permitted, it expanded coverage and absorbed additional costs.

The decision to provide coverage is determined by the owner's ability to pay. The prudent business owner is not likely to make a drastic commitment until he or she is confident the company can handle the costs. Often, given the significant cost of dependent coverage, the company starts by contributing only a small share of family coverage, perhaps only 20 percent, but it does offer the employee the opportunity to secure coverage. Again, as time goes on, the package is improved. H.R. 1864 eliminates that flexibility. In a sense, the decision becomes an "all or nothing" decision. The result is that an owner will postpone the decision to provide any coverage until he or she is confident that the company can consistently and comfortably handle the costs of coverage. The proposal, as drafted, is too rigid to encourage employer activity. Fixed dollar limits only serve to delay coverage. Also, geographic variations make dollar limitations unworkable.

It is not unusual for premiums to be set on an individual basis in small firms. It seems unfair to penalize an employer if an employee has a medical condition that requires the payment of as significant additional premium for coverage. A system that provides flexibility in the sharing of the responsibility will, more likely, encourage employers to provide coverage. Therefore, we would urge the use of percentages to provide an incentive to encourage employers to provide coverage.

Second, we would suggest that wage growth is not the proper index for making future adjustments in the contribution levels. Health care cost inflation is probably in the top three of small business owner's overhead

problems. No amount of planning or budgeting has helped a small business owner in this regard. If there is one lament we hear time and time again, it is, "When is this going to stop, my insurance carrier has just advised me of another 30, 50 even 70 percent increase in my costs." Any index, to be useful, must be linked to those unpredictable costs.

Finally, we come to the issue for which there is no easy answer. The problem is, H.R. 1864 moves a step closer to imposing employer responsibility for employee welfare, which small business owners perceive to be unnecessary and unwarranted government interference. Small businesses value their employers and we believe, voluntarily, attempt to do whatever they can to address their needs. This must be accomplished, however, within the context of the owner's judgment of what the business can accommodate to survive and prosper.

We know the taxpayer is already making a significant tax expenditure to encourage employers to provide health insurance coverage. It is the incremental change, advanced by the House bill, to which small business owners will object. It is the perceived limitation on the small business owner's flexibility in the management of the business that is the cause of significant concern.

It has been our philosophy, in recent years, to make every effort to disseminate information to small business on new regulatory programs as quickly as we can. We do this through compliance guides and seminars. The Immigration and Naturalization Service's (INS) I-9 program and OSHA's Hazardous Communication (HCS) program are two examples of programs for which SBLC undertook major education initiatives. We believe it is our responsibility to accept the mantle of leadership and promote cooperation between the government and small business. On occasion, our efforts to educate reveal the flaws in these regulatory schemes.

Typical of the response we have heard from small business, is the story told to us by Valerie Hansen, Chief Executive Officer of Big Buck Building Centers of Racine, Wisconsin. Valerie is a member of an SBLC member, the National Lumber & Building Material Dealers Association. Her company is 50 percent retail, with two traditional full-service lumber yards, and 50 percent wood-products manufacturing, with a truss plant and architectural millwork company. In 1988 her company's gross sales were $11 million. The company currently employ 88 people; 80 are full-time and some of the employees are covered by union contracts.

It is an established company, having been founded sixty years ago by her grandfather. That means they have survived the Great Depressions, World War II, material shortages, wage and price controls, inflation, and sky-high interest rates. One year in the early 1980's, their home town of Racine issued only one residential building permit. As she says: "We are resilient folks in a highly competitive industry."

As a small business owner, her goal is to serve her customer's needs in a timely fashion and at a fair price. She has observed that: "As a lumber dealer, I need to focus on my customers and the efficient purchasing and delivery of goods. I also must focus on employee growth, team building, improving productivity, and leading the company through its seventh decade."

With regard to Section 89, her company has already invested $3,000 in preliminary data collection and in simply trying to understand the regulations. Her best guess is that she may be able to finish the actual test and comply for $7,500 or roughly $94 per person. At the current corporate tax rate of 34 percent, she estimates this will cost the federal government $2,550 in tax revenue. She anticipates no ultimate liability to her company from Section 89.

Her current annual cost for providing employee health coverage is $189,000. And health care is just one of many employee benefits the company provides.

How significant can the cost of providing health insurance be on her total business? The numbers, based on patterns that already exist, are illustrative. Her analysis is based on information from the top half of the lumber and building material industry — in other words, good, solid companies.

Over the past several years, the average employer cost of providing health care benefits in her industry has averaged 1.8 percent of gross sales. Her health care costs have averaged 2.0 percent of gross sales. Assuming a 5 percent increase in gross sales volume per year, and assuming optimistically they experience a 5 percent increase in gross profits per year, how long will it take until the very viability of the business is threatened if the cost of health care benefits increases 20 percent per year, while all other expenses (such as salaries, insurance, etc.) are held to 5 percent increases?

She tells us it would be seven years. She estimates that in seven years the top firms in her industry will face operating losses instead of profits, with health care coverage as the only item out of balance to other basically inflationary increases. It can certainly be argued that 20 percent is a conservative number. Many small businesses have experienced premium increases in the 50+ percent range and limitations on the coverage of the insurance they can afford. This extrapolation is based on continuing to cover the employee group as it is presently defined, without the additional mandates of Section 89.

Her company has completed a Section 89 "pre-test" to develop basic date on her employees. In doing so, they looked at all W-2 employees for two years. One hundred-ninety-five employees were examined and forms were completed for each. About one-half were union members, being fairly evenly divided between the Teamsters and Carpenters Unions. The preliminary analysis is that neither union contract, as presently structured, will meet the Section 89 requirements. Both involve health plans controlled by an independent group of trustees. The current Teamsters' contract expires July 1, 1989. The contract is traditionally for three years and involves multiple employers covering two counties in southeastern Wisconsin.

Her conclusion, after reviewing the likely impact of Section 89 on her business, was to tell us: "Small business persons are vitally concerned about affordable, quality health care for themselves and their employees. For the most part, small business owners know their employees on a personal level. And, ultimately, we know that our employee's best interest is directly served by maintaining a viable business. Mandates, like Section 89, diminish small businesses' ability to be profitable and do little to meet the individual needs of employees."

We believe any regulatory scheme should allow small business owners an opportunity to bring their programs into compliance. Whether it is the OSHA HCS program or Section 89, the penalties should be prospective, contingent upon failure to comply within a certain time frame once an agency has served warning upon the individual company.

We believe that Congress should not require small businesses to jump through the "hoops" at every turn. Once a small business owner has brought his or her program into compliance, the owner should be permitted to rely on its efforts without going through the machinations necessary for compliance, year in and year out. In effect, we need a "stand-still" agreement with the government, good for a period of time.

The final problem we have with the current Section 89, is the lack of effective communication by the government. Congress and the IRS must ensure that small business owners understand their responsibilities before the effective date and this communication must consist of more than notice of the effective date. As I indicated earlier, we understand we have a responsibility as well. While not perfect, the INS' I-9 program is a good model of how to communicate. The INS did undertake a major effort to inform the business public of the requirements through the dissemination of written and video material. In fact, if I recall correctly, the INS used the IRS list of business establishments for distribution of this information.

In the case of Section 89, we believe this would have reduced the likelihood of mass hysteria. For example, most small business owners automatically assume Section 89 applies to all benefits. They assume it applies to automobiles, vacations, tickets to events or memberships in clubs. Clear, simple information, in advance would have eliminated some major headaches. Unfortunately, small businesses are still working to comply with the relatively recent changes in fringe benefit rules, and in many instances do not fully understand which benefits are includible or excludible from the employee's income. This confusion includes the proper application of definitions of working condition fringe benefits and de minimis fringes. We believe early dissemination of this type of information is essential.

Section 89, as it is presently structured, fuels a dilemma with which small business is confronted on an all too frequent basis. Complicated regulatory requirements create an underground community of owners who say, "This is just too difficult, I'll take my chances and wait to see if they catch me." We do not want that to happen, and we believe most small business owners do not want it. We know some owners will eliminate jobs if Section 89 is left as it is. Others will simply eliminate every employee's benefits. The way to ensure compliance is to be realistic and flexible in the development of laws and regulations.

We find a new undercurrent within the small business community. Under the patina of optimism, lies a layer of frustration. For the first time in a decade, we have heard small business owners suggest the price of doing business is just too high, and the price of doing business is paperwork and regulation. In this nation, we assume entrepreneurship has perfect elasticity; that is, no matter what the cost of entry, more Americans will want to own the American dream. It may not be so. A few examples of the relatively new regulatory schemes with which small business must comply include the I-9 program imposed by the Immigration Reform and Control Act; the Hazardous Communication Standard Program; the underground storage tank program; the hazardous waste program created by the RCRA; several other tax compliance items, such as the passive/active rules; new transportation licensing requirements; plant closing notification rules; polygraph-use restrictions and notice; and, new credit card disclosures. State and local governments have also initiated unprecedented oversight of business.

Small business has always taken the attitude, "We'll survive it." This time, let's not make their job any more difficult, let them go about the business of doing business, not government homework. Thank you.

June 8, 1989

The Honorable Lloyd Bentsen, Chairman
Senate Committee on Finance
United States Senate
SD-205 Dirksen Senate Office Building
Washington, DC 20510

Dear Mr. Chairman:

I wish to offer some comments on your bill to revise Internal Revenue Code Section 89, S. 1129. We are pleased to see that many of our concerns with prior proposals, which we have expressed to you, have been addressed, in whole or part, by your bill. While repeal has been our preferable course, we appreciate the fact that the concerns of small business were heard and recognized by you. Putting aside the debate over the principle, we see a few significant technical problems remaining in S. 1129.

First, we still believe the appropriate threshold for the inclusion of a worker for testing purposes is 30 hours a week. While you have addressed this problem, the bill does so in a way that underscores the problems created by Section 89 in the first place. S. 1129 includes both

a special rule for employees working 25 to 30 hours a week and a transition rule for small businesses. It adds up to complexity. In most firms, and for insurance purposes, full time employees work at least 30-hours a week. We urge you to adopt this single, bright line based on long-standing practice.

Second, the aggregation rules of S. 1129 will leave many small business owners bewildered. We understand that, in some cases, those aggregation rules work to the benefit of the highly compensated employees, but the rules do require owners to undertake some exacting computations. The aggregation rules cannot be explained without considerable effort. We would suggest that S. 1129 tries to accomplish too many social objectives in one leap. We believe there has not been any evidence introduced that demonstrates small businesses abuse the tax code to the extent suggested by the adoption of current Section 89. Somehow the right balance has to be struck. We fear the aggregation rules of S. 1129 remain too complex.

As you know, we believe the issue of "medically uninsurable" to be an important one. We are pleased to see that you have included a provision in the bill. We offer the suggestion that the Congress' up-front guidance on how the term is defined will be important.

As to the definition of a highly compensated employee, we believe, as with officers, owners should not automatically be considered highly compensated. There are too many small business owners making less than $45,000 annually to justify the extra burden.

The final area for which guidance will be necessary, is to ensure that business, Congress, and the IRS will all be in agreement as to what constitutes "are eligible to participate."

Mr. Chairman, we appreciate the fact that your bill moves from actual participation to eligible to participate. Likewise, we believe altering the 90-percent test to be based on all employees rather than just nonhighly compensated employees is more realistic. Other positive provisions include:

- Individual rating
- Percentage test for affordability
- Permitting employers to correct flaws without penalty
- Permitting employers to offer coverage to individuals in otherwise excludible employee categories
- Addressing the medically uninsurable problem for small employers

Again, Mr. Chairman, we appreciate the fact that, although we may disagree as to the best course of action to deal with Section 89, you have demonstrated the willingness to listen to the concerns of small business.

We hope our comments are helpful to you as you proceed to mark-up.

Sincerely,

John S. Satagaj
President

Testimony to the United States Senate
Committee on Finance
Internal Revenue Code Section 89 Nondiscrimination Rules
May 30, 1989
Richard A. Raup, President
Business Administrators and Consultants, Inc.

THE SOCIETY OF PROFESSIONAL BENEFIT ADMINISTRATORS
2033 M Street, NW, Suite 605, Washington D.C. 20036 (202) 223-6413

SPBA is the national association of independent Third Party Administration firms (TPAs) of employee benefit plans. It is estimated that one-third (1/3) of all U.S. workers, from every size and format of employment, are covered by employee benefit plans managed by such firms. Over 90% of the TPA firms known to be eligible for SPBA have joined. Firms must be independent at the Board level and derive at least 50% of their income from TPA services.

SPBA member TPA firms operate much like independent CPA or law firms...providing continuing professional outside claims and benefit plan administration for several client employers and benefit plans. Most of the plans include some degree of self-funding. SPBA is unique, not only in the large percent of benefit plans represented, but also because it includes every size and type of employment, such as: small business, big corporations, union, non-union, association-sponsored plans, and every industry & profession. Thus, SPBA is known for its candid insights, its broad perspective, and that it has no "axe to grind" for or against any particular industry or type of plan.

SPBA membership has grown over 700% in the past 7 years, with a current roster of about 400 TPA firms. This growth mirrors the expanding demand for TPA services...in large part because of the leading role SPBA members have played in successful health cost containment efforts, cost-efficient administration techniques for pension & health benefit plans, and attention to complex government compliance requirements.

Mr. Chairman, and members of the Committee, my name is Richard Raup. I am President of Business Administrators and Consultants, Inc., a Third Party Administration firm specializing in employer-provided health insurance plans. These comments are submitted on behalf of the Society of Professional Benefit Administrators (SPBA), the national association of over 400 Third Party Administration firms, of which I am Chairman. These firms administer employee benefit plans for small and large employers, state and local governments, union and non-union plans, and association-sponsored plans.

I would like to begin by commending you, Mr. Chairman, on requesting comments concerning Internal Revenue Code Section 89. The time and effort you are taking to understand the numerous problems confronting employers with respect to this law is greatly appreciated.

The Society of Professional Benefit Administrators has been encouraged by the introduction of bills that would simplify the Section 89 statute. SPBA applauds Senator Pryor and all the co-sponsors of S. 654 for recognizing the onerous administrative burdens imposed by the statute and thereby creating a safe harbor for some employers. SPBA also welcomes the introduction of H.R. 1864 that would significantly reduce the time-consuming and costly data collection burdens of the present statute.

The following comments discuss issues that have not yet been resolved in the pending Section 89 legislation. In addition, these comments provide suggestions for amending H.R. 1864.

Qualification Requirements

Present-law Section 89(k) requires that certain employee benefit plans (i.e., accident or health plans under Sections 105 and 106, group-term life insurance plans under Section 79, dependent care assistance programs under Section 129(d), cafeteria plans under Section 125(c), fringe benefit programs providing no-additional-cost services, qualified employee discounts, and employer-operated eating facilities under Section 132) satisfy five requirements: 1) the plan must be in writing; 2) employees must receive reasonable notification of the benefits available under the plan; 3) the employees' rights under the plan must be legally enforceable; 4) the plan must be maintained for the exclusive benefit of employees; 5) the plan must be established with the intention of being maintained for an indefinite period of time.

Since these requirements appear to be reasonable and straightforward, many employers assumed that they would not pose any problems for plans. However, that assumption was based on the Section 89 statute and legislative history as contained in the General Explanation of the Tax Reform Act of 1986, written by the Joint Committee on Taxation. After the issuance of IRS proposed regulations, the difficulties with these requirements became apparent for the first time.

The problem with the qualification requirements is that they place an unnecessary burden on employers to determine how their plans, which are already in compliance with similar rules under the Employee Retirement Income Security Act (ERISA), must be changed to comply. As stated in the IRS proposed regulations, the reporting, notification and written plan document requirements are "in addition to, and not in lieu of, any requirements otherwise imposed on employer-provided benefit plans by Title I of ERISA or any other provision of law" (p. 91B). Consequently, employers must spend time and resources comparing the new IRS proposed rules with those under ERISA, as contained in Department of Labor regulations (29 CFR §2520.-104). When employers ask themselves if this added expense is necessary given the existence of parallel requirements under ERISA, they are unable to derive an answer and thus conclude that the time and money required to perform this comparison is not well spent.

If the qualification requirements that differ from those under the ERISA Department of Labor regulations serve an important purpose, then the effort employers must expend is justified. However, if these differences fail to serve any reasonable purpose, then the qualification requirements are deserving of the same criticism that the present-law nondiscrimination rules have received. That is, the requirements force employers to waste resources in an effort to prove something to the IRS that the employer already knows. Employers strongly resent having to satisfy these IRS requirements when they have already satisfied similar requirements for the Department of Labor.

Employers and plan administrators recognize that the requirements under the Department of Labor regulations with respect to the writing, reporting and notification of employee welfare plans were established for valid reasons. The protection of plan participants in employee benefit plans is a well-respected purpose of these regulations. The

Department of Labor gave careful consideration to these rules, reflected on comments from plan administrators and based on those responses, issued final regulations that were accepted by employers.

In contrast, when employers ask themselves why the IRS has issued proposed regulations that differ from Department of Labor rules, they are unable to find any reason other than to raise revenue. Many employers believe that the IRS is purposely trying to set a trap for the unwary. For example, a struggling small employer who can not afford to hire a benefit attorney and simply does not have the time to spend analyzing the new IRS Section 89 proposed regulations will most likely assume, based on an initial reading, that the summary plan description required under Department of Labor rules will satisfy the Section 89 notice requirement. If this small employer is unable to hear the speeches of IRS and Treasury Department officials who have been warning employers to closely examine the contents of the summary plan description to ensure Section 89 compliance, this small employer is most likely to be ensnared in the qualification trap.

Notification.- Under the notification requirement in the Section 89 proposed regulations, all eligible individuals must receive notice of the terms of the plan "prior to the first day on which coverage is provided under an insured or insurance-type plan or benefits are available under any other type of plan and prior to the effective date of any material amendment, extension or modification of such coverage or benefits, and no later than a reasonable time prior to the availability of any election with respect to participation under such plan" (Q&A 5 (g)(1)). In the following paragraph, Q&A 5 (g)(2), the proposed regulations permit a period of 60 days to satisfy the notice requirement if there is a modification to the plan (including any change in plan design).

These regulations conflict with similar rules under Department of Labor regulations. While the "material terms" of a plan that must be included in the IRS notice are also required in the Department of Labor summary plan description, the Department of Labor regulations give employers 120 days to furnish this information to plan participants under a newly established plan and 210 days in the case of a modification to a plan already in existence. In many cases, this length of time is not needed. However, the Department of Labor provided this period for the exceptional cases where an employer and insurer or third party administrator (TPA) can not agree on the legal wording of the plan.

The process of choosing the correct wording for the summary plan description can be protracted. For example, on March 1 an employer decides to establish a new plan for employees with coverage beginning on April 1. The insurer or TPA prepares a summary plan description draft which is sent to the employer for approval. It is not unreasonable for the insurer or TPA to take one to two weeks in preparing the draft. When the draft summary plan description arrives in the employer's office, the employer usually does not drop all pressing business matters to examine the document. Instead, the employer may need one to two weeks to thoroughly read the document and feel confident in sending it to the next level of review, the employer's benefit attorney. By the time the attorney receives the draft document, the effective date of the plan (April 1) has already arrived. If the attorney approves the draft, the insurer or TPA needs at least a week to ten days for copying the document and mailing it to the employer for distribution to employees. However, if the attorney objects to certain provisions, the summary plan description is returned to the insurer or TPA for redrafting and the approval process begins again. This

approval process may seem excessive or unnecessary; however, it is no more excessive or unnecessary than the IRS and Treasury Department approval process for regulations.

Delays in the effective date of coverage will result from the IRS notification requirement. If an employer decides on March 1 to create a new plan for employees with an April 1 effective date, insurers and TPAs will have to inform the employer that coverage should not become effective until all parties (the employer, benefit attorney, etc.) have agreed on the technical language of the summary plan description. The employer must be warned that if the parties can not agree before the effective date of the coverage or within 60 days after the effective date of any future plan modifications, the employer may be in violation of the qualification requirements.

While the Section 89 proposed regulations provide a correction period of 90 days in the case of a de minimis failure with respect to the notification requirement, this grace period fails to reduce employers' anxiety. For an employer to use this grace period, the employer must demonstrate that a good faith effort was made. A clear definition of a good faith effort is not provided in the proposed regulations. Employers are concerned that their definition of a good faith effort may not coincide with IRS' definition. The proposed regulations empower the IRS to use discretion when enforcing this good faith compliance provision and leave the employer subject to the whims of IRS auditors.

In creating the notification requirement under Section 89(k), Congress attempted to ensure that employers would inform plan participants about the coverages available. However, it is customary for employers to provide employees with summaries of available plans (different from summary plan descriptions) prior to election periods so that employees may make informed decisions as to which benefit plan would meet their individual needs. These summaries are usually about three pages in length and do not contain all the information that is required in the summary plan description. Based upon these summaries, employees have enough information to select a benefit plan without being burdened with numerous summary plan descriptions that employees would never have the time or curiosity to read. After an employee selects a benefit plan, the summary plan description follows within 120 days and upon receipt the employee can then become well-versed in the details of the plan.

The Department of Labor regulations acknowledge the practices in operating an employee benefit plan by requiring summary plan descriptions to be given to plan participants. By contrast, the IRS proposed regulations require that all eligible employees (defined as those individuals who participate under the plan or are described in the plan as eligible to participate) must receive "notice" of the terms of the plan. As mentioned above, eligible employees are not interested in receiving detailed information about a plan until they are actually participating in the plan.

More importantly, employees have traditionally considered the receipt of detailed plan information to signify that coverage is in effect. Employers are concerned that employees who receive numerous notices describing different benefit plans will assume that they are covered under all these plans.

Recommendation: SPBA strongly urges that an employer be permitted to satisfy the notification requirement by providing a very brief summary (approximately three pages) of the plans available to employees. The information contained in this summary should be

consistent with the information that employers are presently furnishing to employees prior to the effective date of coverage and not as detailed as the summary plan description.

Under the IRS Section 89 proposed regulations, a list of items that must be included to fulfill the notification requirement is provided. One such item is a summary of the terms of the plan. To an experienced benefits administrator, a summary of the terms of the plan means at least a twenty to thirty page document. The extent to which these items must be described in the "notice" should be clarified through Section 89 legislation.

NOTE: Attached is a chart comparing the IRS Section 89 proposed regulations with the Department of Labor regulations for summary plan descriptions.

Single Written Document - Under the IRS Section 89 proposed regulations Q&A 3 (c) (3), the single written document must include any information or term required by any other applicable provision of the Code or accompanying regulation. This is another area of the proposed regulations where employers believe that the IRS is purposely setting a trap for those who lack knowledge about all applicable Code provisions.

Recommendation: SPBA requests that the IRS be required to list the applicable Code provisions that must be included in the single written document so that employers will not have to be concerned about an unintended oversight.

Legally Enforceable - Under the legally enforceable requirement as described in the IRS proposed regulations, employers are prohibited from exercising discretion with respect to granting or denying coverage and eligibility to employees unless the discretionary methods used are clearly explained in the plan documents and communicated to plan participants. For example, health coverage that is conditioned on a qualified medical opinion of a physician and a managed care program are considered permissible discretions. The purpose of this rule is to prevent an employer from favoring certain employees over others with respect to the receipt of employee benefits after the terms of the plan have been established and explained to participants. At first glance, it would be difficult to argue against a rule having such an honorable intent. However, situations that arise in the ordinary operation of employee benefit plans demand a change in the impermissible discretion rules.

While the IRS recognized that the legally enforceable requirement had to contain safeguards to protect the viability of managed care programs, the IRS failed to see the need for employer discretion in other areas. For example, an employee's claim is denied under the plan and the employee appeals the denial under ERISA review rights only to be told that the plan is not required to pay the claim. Frustrated and convinced that the plan language indicated otherwise, the employee decides to file suit against the employer for misrepresenting the benefits provided under the plan. The employer, concerned about the cost of legal advice to defend the plan language, chooses to pay the employee's claim instead. However, the employer can not make this choice without considering the consequences under the legally enforceable requirement. If the employer fails to amend the plan document to reflect the new coverage provided to this one employee or fails to continue the new coverage for at least 12 continuous months, the employer will be in violation of the qualification requirements and subject to a penalty tax.

Recommendation: SPBA urges that an employer be allowed to pay the type of claim mentioned above without having to expand coverage to all plan participants for a 12-month period.

In addition to the situation described above, there are other circumstances that warrant a relaxation of the legally enforceable requirement. For example, an employer may choose to assist a sick lower-paid employee with medical claims that are not covered under the company plan. However, the employer can not afford to extend this benefit to all employees for 12 consecutive months. Under the IRS rule, employers will no longer be able to help employees when they are in need for fear of incurring a penalty tax. Although Congress focused on eliminating discretion in favor of the highly compensated employees when creating the legally enforceable requirement, this rule will probably hurt nonhighly compensated employees more often.

Indefinite Period of Time - A benefit that is in effect for 12 consecutive months is considered to have satisfied the requirement that a plan be established with the intent of being maintained for an indefinite period of time. The IRS proposed regulations permit a plan with coverage in effect for less than 12 months to satisfy this requirement if the employer can demonstrate that there is a substantial business reason for modifying or terminating the plan. However, changes in insurance carriers or health care providers are not considered valid reasons for modifying or terminating plans.

While the IRS must be commended for giving financially distressed employers a reprieve from the 12-month rule, the IRS overlooked other circumstances that deserve special treatment. For example, a small employer contributes to a group plan because the cost of providing coverage to employees is otherwise prohibitive. If the group plan experiences financial difficulty and can no longer pay claims, the small employer could be left with substantial unpaid claims and may be unable to find other coverage at a reasonable cost.

Recommendation: SPBA urges that the qualification penalty tax be removed when an employer's group plan becomes insolvent.

Reporting Requirements

Present-law Section 89 amends Internal Revenue Code Section 6039D by expanding the definition of a "fringe benefit plan" to include plans under Section 79 (group-term life insurance), Section 105 (amounts received under accident and health plans), Section 106 (contributions by employers to accident and health plans) and Section 129 (dependent care assistance programs). Prior to the passage of Section 89, Section 6039D applied only to plans under Section 120 (group legal services), Section 125 (cafeteria plans), and Section 127 (educational assistance plans).

This represents a dramatic change because Section 6039D requires all employers to file an annual return/report (i.e., 5500 Form). Unlike the Department of Labor regulations on 5500 Forms, Section 6039D permits no exemptions for plans with under 100 participants. Thus, small employers providing health insurance plans to employees will now, for the first time, be burdened with having to file annual reports. This will take time and resources that small employers simply can not afford to sacrifice on bureaucratic paperwork.

Recommendation: An exemption from Section 6039D should be provided to plans having fewer than 100 participants.

Recommendations for H.R. 1864

Employee Contribution Rates - Indexing the employee contribution rates to average wage growth poses insurmountable problems. With the rapidly escalating health care inflation rate, employers will be required to pay an increasingly greater portion of health insurance costs. If the employer is forced to absorb these rising costs and thus shelter employees from this national problem, the employer will respond in one of three ways: 1) eliminate coverage; 2) raise deductibles; or 3) reduce the level of benefits offered. In raising deductibles, another form of discrimination will surface because only higher-paid employees will be able to afford to pay the deductibles. To prevent this, H.R. 1864 should be amended to index the employee contribution rates to the medical inflation rate or replace employee dollar limits with an employer-paid percentage of the total health care cost.

Another problem with the employee contribution rates concern plans that employ composite rates. Under these plans, single employees and employees with families pay the same amount for health insurance even though they derive different benefits. H.R. 1864 should be amended to permit the existence of composite rate funding structures where the composite rate does not exceed the average of the maximum single and family employee contribution rates.

Testing Date - H.R. 1864 retains the present-law nondiscriminatory provision requirement for the selection of a testing date. Under this requirement, any provision of a plan may be deemed discriminatory even if the plan passes the numerical nondiscrimination tests. Since this is a subjective test, employers are concerned that the IRS may challenge any testing date the employer has chosen. Employers fear they will have to defend their choice of testing dates every day of the year. H.R. 1864 should be amended to provide the employer with more security in his choice of testing dates; the IRS' power to challenge testing dates should be checked.

State and Local Governments - H.R. 1864 amends the definition of highly compensated employees so that an employer does not have to consider an officer a highly compensated employee when no officers are receiving compensation in excess of $45,000 a year. While this amendment was included in H.R. 1864 to facilitate Section 89 compliance for state and local government plans, problems still remain. Branches within state and local governments usually have very different benefit structures primarily because the benefits are funded from different taxes. For example, the benefits provided to employees in one branch of government may be funded by a lean state motor vehicle tax, while the benefits for another branch may be funded by a fat sales tax. If these branches can not pass the separate line of business test, they must be aggregated for testing purposes and may not pass the benefits test under H.R. 1864. H.R. 1864 should be amended to allow state and local governments to test separately regardless of whether they can pass the separate line of business test.

Cafeteria Plans - H.R. 1864 poses major problems for cafeteria plans. As the bill is presently worded, the use of salary reduction plans is prohibited. As the cost of health insurance has risen, employers have turned to the salary reduction arrangement in an effort to control cost and thereby have been able to sustain the existence of plans.

Valuation Method - H.R. 1864 retains the present-law rule for determining the value of employer-provided benefits. Under this rule, an employer may use premium cost or any reasonable valuation method until the Secretary of the Treasury issues valuation tables. H.R. 1864 should be amended to allow valuation based on premium cost even after these tables are issued.

Thank you, Mr. Chairman, for giving careful consideration to my testimony. I look forward to further discussions with you concerning this important matter.

SPBA SOCIETY OF PROFESSIONAL BENEFIT ADMINISTRATORS
2033 M Street, NW • Suite 605 • Washington, D.C. 20036 • (202) 223-6413

Side-by-Side Comparison of the Department of Labor Requirements for Summary Plan Descriptions and the Internal Revenue Service Section 89 "Writing" and "Notification" Requirements

	DOL	IRS
Timing of plan information to participants	In general, the summary plan description must be distributed to participants within 120 days after the effective date of a newly established plan.	In general, all "eligible individuals" must receive a "notice" containing a summary of the plan prior to the first day on which coverage is provided and prior to the effective date of any amendment, extension or modification of benefits, and no later than a reasonable time prior to the availability of any elections. The "notice" must contain a statement that a "single written document," explaining further the provisions in the "notice," is available for inspection and that the terms of the "notice" are "legally enforceable."
Timing of modifications to participants	A summary of any plan modification (whether a substantial change in coverage or simply a clarification) must be provided to plan participants no later than 210 days after the close of the plan year in which the modification was adopted. This summary must be filed with the Secretary of Labor no later than 210 days after the close of the plan year in which the modification was adopted.	A plan modification must be provided to plan participants no later than 60 days after the effective date of the modification. While the IRS would prefer to have plan participants notified of modifications prior to the effective date (as noted in the regulations), a 60 day grace period is permitted.
Plan information available upon request	The plan administrator must furnish certain material to individual participants upon their request. The plan administrator must make certain material available to participants and beneficiaries for inspection at reasonable times and places. The administrator shall, upon written request of any participant or beneficiary, furnish a copy of the latest updated summary plan description, plan description, and the latest annual report, any terminal report, the bargaining agreement, trust agreement, contract, or other instruments under which the plan is established or operated. The administrator shall make copies of the plan description and	A "single written document" (including all related documents incorporated by reference) must be available for inspection. This document must provide an explanation of the "notice" (mentioned above). Provided that the "notice" is given to participants prior to the first day of coverage, the "single written document" need not be completed until 120 days after the effective date of the new plan or modification. The employer need not provide a copy of the "single written document" to all "eligible individuals" unless they request the information. Note: If the "notice" requirement is not satisfied, the "single written document" along with all

	DOL	IRS
	the latest annual report and the bargaining agreement, trust agreement, contract, or other instruments under which the plan was established or is operated available for examination by any plan participant or beneficiary in the principal office of the administrator and in such other places as may be necessary to make available all pertinent information to all participants.	modifications must be in writing prior to the first day of coverage.
What must be included in plan information?	What follows is an overview of the contents of a summary plan description. The summary plan description shall include: the name and address of the employer or trustee of the plan (for a collectively bargained plan, a statement that a complete list of the employees and employee organizations sponsoring the plan may be obtained upon written request to the plan administrator); the type of administration of the plan, e.g. contract administration, insurer administration; if a plan is maintained pursuant to a collective bargaining agreement, a statement that the plan is maintained as such and that a copy of any such agreement may be obtained by participants and beneficiaries upon written request; eligibility requirements, including a statement of the conditions pertaining to eligibility and a description or summary of the benefits (in the case of a medical care plan providing extensive schedules of benefits, only a general description is required if reference is made to detailed schedules of benefits which are available without cost to any participant who so requests); a statement identifying circumstances which may result in disqualification, ineligibility, or denial, loss, forfeiture or suspension of any benefits that a participant or beneficiary might otherwise reasonably expect the plan to provide on the basis of the description of benefits; the sources of contributions to the plan and the method by which the amount of contribution is calculated; the identity of any funding medium used for the accumulation of assets through which benefits are provided; the procedures to be followed in presenting claims for benefits under the plan and the remedies available under the plan for the redress of claims which are denied in whole or in part; the statement of ERISA rights; a summary of the plan's termination procedure.	The "notice" that must be provided to "eligible individuals" must contain a fair and complete summary of the terms of the plan that are reasonably likely to be of significance to an "eligible individual." These terms must include at least the following: a general description of who is eligible to participate in the plan; a general description of the coverage or coverages offered (including the general types of benefits provided under the plan, basic limitations on such benefits and required deductibles and co-payments); the timing and method of any election to participate; the cost to the employee relating to the plan, whether by way of salary reduction or employee contributions; the method by which a copy of the plan may be obtained; and the name and means of contacting a person from whom to request further information about the plan. The "single written document" (to be maintained in an employer's file) must include a statement that the plan is "legally enforceable" and that the plan is maintained for the exclusive benefit of employees. Any information or term required by any other applicable provision of the Code or accompanying regulation must also be included. Most of the information included in the "single written document" will describe an employee's rights to be covered by, participate in, or benefit under a plan. This information must not only include all the information required in the "notice" but also the following: terms relating to the periods during which coverage or benefits are provided; the extent to which elections are irrevocable; the manner in which employer contributions may be made; conditions regarding a participant's qualification or continued qualification for coverage, including pre-existing condition limitations; provisions relating to the procedure under which claims are to be made and evaluated for reimbursement; provisions relating to health continuation coverage; and the procedures or circumstances under which the plan may be terminated.

	DOL	IRS
Method of Notification	The plan administrator shall use measures reasonably calculated to ensure actual receipt of the material by plan participants. Material which is required to be furnished to all participants covered under the plan must be sent by a method or methods of delivery likely to result in full distribution. For example, in-hand delivery to an employee at his or her worksite is acceptable. However, in no case is it acceptable merely to place copies of the material in a location frequented by participants. It is also acceptable to furnish such material as a special insert in a periodical distributed to employees such as a union newspaper or a company publication if the distribution list for the periodical is comprehensive and up-to-date and a prominent notice on the front page of the periodical advises readers that the issue contains an insert with important information about rights under the plan and the Act (ERISA) which should be read and retained for future reference. If some participants are not on the mailing list, a periodical must be used in conjunction with other methods of distribution such that the methods taken together are reasonably calculated to ensure actual receipt. Material distributed through the mail may be sent by first, second, or third-class mail. However, distribution by second or third-class mail is acceptable only if return and forwarding postage is guaranteed and address correction is requested. Any material sent by second or third-class mail which is returned with an address correction shall be sent again by first-class mail or personally delivered to the participant at his or her worksite.	The Section 89 regulations reference the DOL regulations (29 CFR §2520.104b-1(b)(1)) for guidance on the method of notification. Thus, the same notification method applies for both IRS and DOL.
Who receives the plan information?	In general, the summary plan description must be distributed to anyone who is considered "covered" by the plan and to anyone who is receiving benefits. However, the summary plan description can be distributed to a person before he or she becomes covered, such as when a new employee begins employment.	All "eligible individuals" must receive a "notice" (summary of the plan). An "eligible individual" is not someone who derives eligibility solely through another individual, such as dependents. An "eligible individual" is someone who participates under the plan or is described in the plan as eligible to participate. An "eligible individual" includes someone whose participation under the plan is conditioned upon an election not yet made or the passage of a waiting period required under the plan. In addition, an "eligible individual" includes someone who is a "qualified beneficiary" (as defined in COBRA). For purposes of notifying "qualified beneficiaries," the definition of "eligible individuals" includes those who derive eligibility through an employee.
Reporting Requirements	The administrator of a plan must file with the Secretary of Labor a copy of the summary plan description on or before the last date on which a summary plan description may be furnished to plan participants (i.e., 120 days after the effective date of a newly established plan).	The Internal Revenue Service does not require a copy of either the "notice" or the "single written document" to be filed with the Service. However, the employer must keep this information on file.

STATEMENT OF SOUTHWESTERN BELL CORPORATION

Senator Bentsen, our appreciation goes to you and members of your committee for the opportunity to submit our testimony. Our appeal is for immediate and effective relief through the passage of legislation that will significantly simplify nondiscrimination testing under Section 89. We applaud Senator Pryor's efforts with the introduction of S. 654 since it is the first reasonable effort at significant simplification. A design based test such as Senator Pryor's and that proposed by Chairman Rostenkowski will enable us to dispatch with the cumbersome rules and time consuming and costly activities of data gathering and testing.

Do not mistake our support as an attempt to exempt ourselves from the nondiscrimination goals that comprise the very backbone of Section 89. Rather, by utilizing a design based (i.e., an eligibility based) test, we are required to assess the actual availability of the plan to the nonhighly compensated as compared to the highly compensated employee in order to make a fair and objective assessment of our plan design. We support the eligibility based test proposed by S. 654.

Based on our experiences, we feel that significant simplification is warranted. Southwestern Bell Corporation supports S. 654 proposing simplification of Section 89. However, the following areas continue to be of great concern to Southwestern Bell Corporation:

- The simplified health arrangement rule should apply to base plans. Employee options (HMOs) should automatically be deemed nondiscriminatory if the base plan passes.
- The definition of "same type of plan" should not be restricted to plans having the same employer-provided benefit. Employers with multiple operating units with various plans should consider plans that meet the applicable premium outlined in the bill as plans of the "same type."
- The simplified health arrangement rule should include provisions relating to 89(g)5 to clarify it can be applied on a separate line of business basis.
- Employee contribution limitations are artificially low. Limits such as those proposed in the H.R. 1864, $10/$25 per week for single and family coverage, are more reasonable and are still in reach of working Americans.

We offer you the following experience as further substantiation of the claim that Section 89 under present law, is far too complicated, costly, and cumbersome for employers.

The administrative burden and consequent cost imposed on employers with undeniably nondiscriminatory plans (as the following example will illustrate) will only continue to erode United States tax revenues. Significant simplification is needed. Simplification should maintain the true intent of Section 89, while providing the necessary relief to those whose intent was clearly not to discriminate by virtue of their plan design.

Southwestern Bell Corporation (SBC) based in St. Louis, is an international communications corporation with approximately 65,000 employees and 26,000 retirees. Through its six principal subsidiaries, Southwestern Bell Corporation provides telephone network services, telephone equipment, cellular mobile telephone service and equipment, paging service and equipment, and directory publishing and commercial printing.

During the first quarter of this year, Southwestern Bell Corporation completed its first preliminary testing using 1988 data on its managed medical plan, that is its base plan, CustomCare, along with the 47 related health maintenance organizations (HMOS). These HMO options are an alternative to the base plan, CustomCare, for eligible employees.

Prior to testing, we assumed that other than the effort and expense of data collection and compilation, Section 89 would pose no problem for CustomCare due to its nondiscriminatory plan design.

CustomCare's nondiscriminatory design features include:

- CustomCare is available to all employees (high and low paid) on the same basis. (There are no differences in eligibility, company contributions, benefit levels, etc.)
- CustomCare does not require any employee contributions by the employee or immediate family dependents, although we support the concept of employee contributions as outlined in Chairman Rostenkowski's bill H.R. 1864. Also, as we completed the exercise of valuing the plans to prepare for testing, it was determined to have a higher value than the available HMO options.
- Southwestern Bell Corporation makes the same company contributions for the HMOs as it does for CustomCare. However, employees voluntarily electing an alternative HMO with a premium cost that is greater than the CustomCare Company

contribution are responsible for paying the difference by way of employee contributions.

CustomCare, at the time of data collection, had a participation rate of approximately 72% of all employees eligible to participate in CustomCare.

This percentage was derived by dividing the total number of employees electing CustomCare by the total number of employees eligible for CustomCare. The remaining employees voluntarily elected to participate in one of the 47 HMO options.

In performing the preliminary tests, Southwestern Bell Corporation utilized the higher value plan rule in order to aggregate plans and perform the 80% coverage test. We recognize that there are other available testing and aggregation options, one of which now appears to be more applicable, i.e., the safe harbor employer cost comparability rule. But, the proposed regulations clarifying this rule had not been released as of the date of testing.

Southwestern Bell Corporation was able to use the 80% coverage test for single coverage and passed with a substantial margin. However, we were unable to apply the 90% coverage test and were barely able to apply the 80% coverage test for family coverage under the higher value plan rule as explained below.

We offer you the following test results only to establish the point that the Section 89 tests as written do not address the design or intent of a clearly nondiscriminatory plan, but rather focus on employee choice.

In applying the higher value plan rule, it was determined that Southwestern Bell Corporation's margin of passage was only 1.7%. This figure was derived by dividing the percentage of nonhighly compensated employees receiving family coverage (44.7%) under Southwestern Bell Corporation's highest valued plan by the percentage of highly compensated employees receiving family coverage (54.7%) under the same plan.

Family coverage was almost discriminatory even though all employees could have elected CustomCare at no cost. If as few as 75 highly compensated employees were to make election changes (i.e., electing CustomCare family coverage), it would have prohibited us from using the 80 coverage test unless we utilized an additional layer of complex aggregation rules.

This assumption is based on the fact that these election changes would result in highly compensated employees acquiring family coverage. (Since there is no charge for family coverage, it is reasonable to assume that all employees [highly compensated employees and nonhighly compensated employees] with families would elect family coverage.)

This test, when applied to noncontributory plans, simply measures family composition by income level. For Southwestern Bell Corporation it seems to prove that we are "almost guilty" of failing to sponsor welfare plans which insure that nonhighly compensated employees will have families in the same proportion as highly compensated employees. To manage this test, we would need to adjust work force composition or incomes for events such as marriage, death, divorce, childbirth, etc. This hardly seems to be the intent of welfare plan nondiscrimination rules. The close margin on the higher value plan rule using 1988 data may force Southwestern Bell Corporation to look toward additional aggregation and testing options such as the more burdensome three-part test in 1989, requiring costly additional data collection just to prove that an incontestably nondiscriminatory plan does not favor the highly compensated. The aforementioned example produces another obstacle that must be taken into consideration. Using the higher value plan rule, we would have been forced to track highly compensated employee election changes during the entire plan year. This effort would include changes that result from marriage, divorce, childbirth, death, and job relocations. We fully support recent efforts both by Members of Congress and groups such as the Section 89 coalition in proposing changes to the current regulations which would require compliance on a single testing date.

To we have spent well over $100,000 for outside consultation, plan valuation and testing. This figure does not include our internal costs which are in excess of our external costs. We project that these internal and external costs will be duplicated with our ongoing efforts during the remainder of 1989.

The expenses incurred by Southwestern Bell Corporation for conducting the nondiscrimination tests result in additional operating expenses to the company which ultimately increase the prices of our products and services to Southwestern Bell Corporation's customers. Additionally, expenses for conducting the nondiscrimination tests are deductible business expenses. Thus, where employers conduct nondiscrimination tests and pass, an erosion of United States tax revenues is realized as no discriminatory excess is imputed, yet business deductions are permissible.

Likewise, tax revenues are affected where an employer conducts the tests and fails unless the imputed income and corresponding individual tax rates are greater than the employer's applicable deduction.

A close examination of the employee profile revealed that Southwestern Bell Corporation's ability to aggregate plans and apply coverage tests is threatened by two principle factors:

(1) Demographics and

(2) Employee voluntary selection of less valuable options (based on their preferences) even though the most valuable option is noncontributory.

The very nature of CustomCare's plan design supports the argument that a clearly nondiscriminatory plan can be construed as discriminatory under Section 89 methodology based solely on demographics and employee choices.

We appreciate the opportunity to express our views to you and your committee. We are committed, as you are, to the efforts directed at simplification of Section 89 and are, therefore, available to you or members of your staff should you require assistance in this effort.

STATEMENT OF THE STATE AND LOCAL GOVERNMENT BENEFITS ASSOCIATION

Mr. Chairman, thank you for the opportunity to present a written statement to the Senate Finance Committee concerning the problems state and local governments have under section 89. The State and Local Government Benefits Association (SALGBA) represents benefits administrators of 31 states, 16 counties and 31 cities. The members of SALGBA deliver benefits to 2 million employees and more than 3 million dependents from coast to coast. Through plans that range from traditional indemnity plans to cafeteria plans, our members deliver benefits to such diverse groups of employees as policemen, part-time bus drivers, professors and clerical workers.

Because we represent state and local governments, SALGBA members have constraints and concerns that may be different from private sector employers. We often have to contend with both statutorily mandated benefits and budget limitations. In addition, we have to balance the benefit needs of our employees with the economic concerns of our taxpayers. SALGBA has been closely watching the efforts to simplify section 89. We support the efforts of Senator Pryor, as well as those of Chairman Rostenkowski, to simplify and streamline nondiscrimination testing under section 89. These bills, however, raise problems in several areas that we believe should be addressed. We ask the Committee to take the concerns described below into, account as it develops its own legislation.

WORKABLE AVAILABILITY TEST

SALGBA believes that a workable availability test is critical to simplified section 89 testing. In order to make such a test workable, however, five problem areas must be addressed.

Affordability: SALGBA believes that limiting affordable benefits to those costing $10 or less per week for individual coverage and $25 or less per week for family coverage (indexed to average wage growth) is too restrictive.

Some state and local government plans charge employees more than those amounts for coverage now, and many more will need to do so in the very near future. Despite the fact that these plans do not meet the proposed affordability requirements, they typically provided very broad coverage of nonhighly compensated employees. As such, the amounts charged employees, although greater than the proposed limits, are clearly affordable.

In addition to raising the initial dollar limits, SALGBA believes that these amounts should be indexed in a manner that reflects the growth of medical costs. Such an index would preserve the allocation of costs between employers and employees as the costs increase. In contrast, indexing the amounts to wages shifts a significantly larger percentage of the cost to employers over a relatively short period of time.

WHO IS A COVERED EMPLOYEE?

Should substitute teachers be covered? The hours normally worked by excludable part-time employees are calculated by disregarding periods of unemployment. Although reasonable in most contexts, when applied to bona fide substitute teachers who are replacing permanent teachers on a temporary basis, the rule does not work. Because such substitute teachers have absolute control over which days they work,

but tend to work full time on days they elect to work, most substitute teachers are considered full time employees under the part-time rule even though, as a class, they generally work less than half-time. SALGBA supports excluding such substitute teachers for testing purposes.

What part-time employees should be covered? Although raising the threshold for excludable part-time employees from 17½ to 25 hours is an improvement, many of the part-time employees of state and local governments work more than 25 but less than 30 hours per week. Providing benefits to such employees would be extremely costly and, in some cases, would require legislative authorization. SALGBA supports raising the threshold for excludable part-time employees to 30 hours per week.

Should the separate testing rule be included in proposed legislation? State and local governments are often legally required to provided benefits for certain part-time employees, but not for others (*e.g.*, bus drivers who work only 15 hours per week receive statutorily mandated medical benefits in one jurisdiction). Under current law the separate testing rule allows employers to disregard employees in the part-time, seasonal, short-service and under-age categories even though some, but not all, employees in those categories are eligible for the same type of benefits—if the tests can be satisfied by such employees considered separately. In contrast, H.R. 1864 eliminates the separate testing rule. SALGBA believes the separate testing rule should be included in any legislation which replaces current section 89.

Who is an employee? Are prisoners in state penitentiaries employees because they are paid minimal amounts to work in-and around the institution? Are shelter employees, who are physically or mentally handicapped but who are paid for work by the state or local government, employees? Are volunteer fire fighters who are paid stipends or allowances employees?

Governments do not provide these groups employment in the traditional employer context, rather these people are employed to relieve unemployment, to provide temporary emergency services or to otherwise fulfill governmental responsibilities. Under I.R.S. Notice 89–23 government employers can exclude such groups when applying the nondiscrimination rules for 403(b) annuities. SALGBA supports extending that exclusion to section 89 testing.

Who is the Employer? There are detailed rules for the private sector describing the circumstances in which disaggregation of employers is possible. There are no such rules for the public sector, and without them public sector employers are faced with tremendous uncertainty: Must they test on a jurisdiction-wide basis? If not, on what basis can they disaggregate?

SALGBA supports the application of the good faith standard in the Technical and Miscellaneous venue Act of 1988 to this area until a reasonable period such as one year, after regulations with guidance on this matter have been issued.

What about Public Employers with Cafeteria Plans? State and local governments sponsor many cafeteria plans that allow employees to buy benefits using salary reduction, which is uniformly available to both highly and nonhighly compensated employees. H.R. 1864 treats salary reduction as employee contributions when made by nonhighly compensated employees and as employer contributions when made by highly compensated employees.

SALGBA believes, however, that salary reduction which meets any applicable dollar limitations and which is matched by adequate employer contributions should be included in determining the value of benefits available to nonhighly compensated employees. In addition, cashable credits, that is employer contributions which can be taken in cash, should be treated as what they are—employer-funded benefits.

Highly Compensated Employees: Under H.R. 1864 employers must be able to identify highly compensated employees and track, on a daily basis, their benefits. If the availability test under H.R. 1864 were modified to apply the 133% rule to compare the average benefits available to nonhighly compensated employees with the average benefits received by highly compensated employees on a snapshot, one-day-a-year basis, the data gathering burdens would be substantially reduced for all employers. In addition, from the employees' perspective, testing based on average benefits is much more predictable: employees who become highly compensated based on overtime pay or moving expenses are less likely to find themselves suddenly taxed on their health benefits. SALGBA supports such an outcome.

ALTERNATIVE COVERAGE TEST

Even with the improvements described above, an availability test will not work for all employers—there will always be some employers in the public, as well as in the private, sector that deliver nondiscriminatory benefits to their nonhighly compensated employees, but who fail the design-based availability test.

SALGBA believes that such employers should be given the option to test their health plans under a simplified coverage test. While some will say that this increases the appearance of complexity, in fact it will have no impact on the vast majority of employers—if workable availability test is enacted. In addition, such coverage-based testing could be made significantly simpler than under current law.

In sum, SALGBA believes that a workable availability test, with an optional coverage test, would best serve the interests of federal, state and local governments. Thank you for the opportunity to submit this written statement.

Statement of Union Oil Company of California (UNOCAL)

Unocal welcomes this opportunity to offer written comments for the record as part of the Senate Finance Committee hearings on revisions to Section 89 of the Internal Revenue Code of 1986.

Unocal is not opposed to reasonable and simplified nondiscrimination requirements for core medical plans. However, the scope and extreme complexity of Section 89 go far beyond what any employer, whether small, medium or large, can realistically cope with. Revisions to Section 89 are urgently needed to encourage employers to continue to provide quality health care programs instead of discouraging these programs as the present Section 89 rules do. Unless Section 89 undergoes major revisions, the provision should be repealed.

Unocal supports the spirit of S. 654, offered by Senator David Pryor, in attempting to provide the necessary relief for employers, but the bill as presently written does not go far enough. Specifically, we believe the bill needs improvement in four major areas:

I. Employee contribution maximums must be realistic and directly related to escalating medical plan costs;
II. More realistic classification of employees and "leased employees" should be used in the eligibility testing procedure;
III. A narrower definition of "leased employee" than is currently contained in Section 414(n)(2) should be adopted; and
IV. Pre- and after-tax contributions to a medical plan should not be accorded different treatment.

I. Employee Contribution Maximums Must Be Realistic and Directly Related to Escalating Medical Plan Costs

Unocal believes the safe harbor provided by the simplified health arrangement proposed in S. 654 is too narrow to be of value to most employers. The employee contribution maximums of $6.70 a week for employee-only coverage and $13.40 a week for dependent coverage are too restrictive and will disqualify many employers who provide quality health care plans for all employees and/or have employees at locations with high medical costs. Even if employee contributions remain below these dollar maximums during the first year or two, the rapid escalation in medical costs would soon surpass the modest indexing provided by cost-of-living adjustments or increases in the minimum wage, thereby jeopardizing the safe harbor. The end result is that employers would than be faced with four choices:

(1) Absorb most of the increases in medical plan costs in order to retain the safe harbor.

(2) Pass on part of the costs to the employees, give up the safe harbor, and attempt to comply with Section 89 testing requirements which are essentially unworkable.

(3) Reduce the cost (and quality) of medical plan coverage by increasing deductibles, increasing "out-of-pocket" limits, increasing employee co-pay percentages, etc., in order to keep employee contributions below the allowed maximums.

(4) Eliminate medical plan coverage.

In a highly competitive business environment, alternative (1) is not viable. Alternative (2) places the employer in the same position that both industry and government officials recognize today as an intolerable situation. Alternatives (3) and (4) are more likely courses of action by employers, but are exactly the opposite of the policy originally intended by Congress.

Unocal believes that the simplified health arrangement portion of S. 654 should be modified as follows:

• The maximum contribution by all full-time employees *should not* exceed 40% of the employer's total COBRA contribution rate;
• The plan must be made available to at least 80% of all Non-Highly Compensated (NHC) employees (90% if leased employees are excluded);
• The maximum contribution by part-time NHC employees should not exceed one and one-half times the contributions of full-time employees; and
• The testing requirements should apply to core health plan coverage only, i.e. medical plans. (Core health plan coverage means a plan providing basic/major medical or comprehensive medical coverage, including prescription drug coverage, but excluding dental and vision care plans and physical examination programs.)

Unocal believes the above changes will provide employers with proper incentives to retain quality medical plans. A percentage-of-cost formula results in employee contributions which are plan-specific and automatically recognizes actual plan costs which vary considerably depending on employer location and plan quality. Such a percentage formula also automatically recognizes the varying contribution structures of most plans, i.e., employee-only, employee and one dependent, employee and two dependents, etc.

A percentage-of-cost formula also provides a method for recognizing future increases in medical costs. This would be preferable to indexing employee contributions to the minimum wage level which is a potentially controversial topic. It is improbable that escalation of the minimum wage level would reasonably correlate with rising medical costs, particularly because of the political sensitivity surrounding upward changes in the minimum wage.

In summary, employees who want quality plans would prefer to pay a fair share of those costs and retain quality coverage, rather than be subjected to a gradually deteriorating plan brought about by government testing regulations that are obscure to the employees.

II. More Realistic Classification of Employees and "Leased Employees" Should Be Used in the Eligibility Testing Procedure

Unocal believes the employee "population" used in the eligibility testing process should be revised to reflect the realistic concept that an employer has less of an obligation or incentive to contribute toward medical plan costs of employees who provide services on a lesser basis than full-time employees. Unocal suggests a 3-tier employee definition:

• "Full-time" employees mean those who normally work 32 hours or more per work week;
• "Part-time" employees mean those who normally work 24 hours or more, but less than 32 hours per work week; and
• "Casual" employees mean those who work less than 24 hours per work week.

For eligibility testing purposes Unocal suggests:

• Full-time employees should be included in the test;
• Part-time employees should be included in the test, but would be expected to contribute a somewhat greater share of the plan cost because of fewer hours worked; and
• Casual employees should be excluded from the test.

One of the most troublesome areas of eligibility testing deals with "leased employees." A "leased employee" is an employee of a contractor performing services for a recipient employer. Nevertheless, such "leased employee" is treated as being the employee of the recipient employer for purposes of Section 89. As discussed more fully in Section "III" below and in Attachment A, an employer recipient is currently faced with a major problem of identifying a "leased employee" because of the present definition of that term in the code.

Unocal strongly urges that the following classifications be excluded from the testing requirements:

• Leased employees (as redefined by Section "III," below), unless the leased employee population exceeds 25% of the employer's full-time and part-time employee population.
• Employees and leased employees covered by a collective bargaining agreement. These individuals have already bargained for, and are receiving, a competitive wage and benefit package.

III. A Narrower Definition of "Leased Employees" Than Is Currently Contained in Section 414(n)(2) Should Be Adopted

If a plan eligibility test based upon a percentage of an employer's employees is to remain a part of Section 89, we strongly urge the Committee to narrow the definition of "leased employee" in Section 414(n)(2). This problem must be addressed to avoid an enormous and virtually unsolvable problem facing nearly all employers in complying with Section 89. For purposes of Section 89, a "leased employee" is treated as an employee of the "recipient" (i.e., the employer to whom services are deemed to be rendered). Thus, Sections 89 and 414(n) are inextricably related and cannot be viewed as separate provisions dealing with separate matters. As discussed in Attachment "A" to these comments, the problem is that the definition of "leased employee is so broad that it could include vast numbers of non-employee workers who should not properly be classified as leased employees of an employer. Unless the definition is modified, employers attempting to apply the eligibility test are faced with a monumental and nearly impossible task of identifying and obtaining information relating to such workers.

IV. Pre-Tax and After-Tax Contributions to a Medical Plan Should Not Be Accorded Different Treatment

The fourth and final area of major concern is that of employee pretax contributions made to a medical plan through a Flexible Spending Account or other voluntary salary reduction program. The proposed "Aggregation Rule" under 5.654 indicates that pre-tax and after-tax contributions would be treated differently for testing purposes. Unocal strongly disagrees with the view that pretax contributions are inherently discriminatory and believes that reconsideration is appropriate. Unocal believes than Internal Revenue Code Section 125 adequately covers potential discrimination under pretax arrangements and additional requirements are unnecessary.

In conclusion, we compliment the Committee in its effort to examine Section 89. Further, we applaud the efforts to develop S. 654, as a big step in the right direction to untangle the maze of data collection, recordkeeping and testing required by Section 89. However, we would also add that, if the relief is too narrow and inflexible, the relief will be more imagined than real, and most employers would continue to be faced with the morass of Section 89 rules as they exist today. We believe this will ultimately result in the reduction or elimination of medical coverage for many employees who are provided with quality coverage through their employers. As mentioned earlier, this would be the opposite result of that originally intended by Congress. Therefore, we urge careful consideration of our suggested changes to help resolve a very complex and unworkable situation for employers.

Thank you for this opportunity to make our views known.

Attachment A.—Discussion of "Leased Employee" Problem

The "leased employee" problem became particularly onerous as a result of the provisions of the Tax Reform Act of 1986, which amended Section 414(n)(3) to include, *inter alia*, Section 89, as a provision subject to the "leased employee" provisions of Section 414(n).

Section 414(n)(2) defines a "leased employee" as follows:

> "Leased Employee" . . . the term 'leased employee' means any person who is not an employee of the recipient and who provides services to the recipient if—
>
> "(A) such services are provided pursuant to an agreement between the recipient and any other person (in this subsection referred to as the 'leasing organization'),
>
> "(B) such person has performed such services for the recipient (or for the recipient and related persons) on a substantially full-time basis for a period of at least 1 year (6 months in the case of core health benefits), and
>
> "(C) such services are of a type historically performed, in the business field of the recipient, by employees."

This provision was enacted with the Tax Equity and Fiscal Responsibility Act without hearings or opportunity for public comment. In 1986 the Treasury Department testified before Congress as to the purpose of the leased employee rules, indicating that the intent was to prevent avoidance of the rules governing qualified pension plans through leasing of employee services. However, the only example given was the leasing of nurses or other staff by a doctor.

Because the statutory definition of "leased employee" is entirely too broad, it sweeps in as potential leased employees a vast number of workers which common sense indicates should be excluded. The definition can be shortcut simply to say that any individual who performs a service for the recipient under any form of an agreement for a period of one year (or 6 months in the case of tests for health plans is a leased employee if the work being done is a type that employees in the business field of the recipient (not the recipient alone) have performed. When one analyzes this definition in the context of the infinite variety of everyday business transactions which affect even a modest sized business, then virtually every worker performing any service which benefits the recipient could be at least a potential leased employee of that recipient. Thus, the employer must first identify such worker' and obtain information in order to determine whether they meet the tests to be classified as a leased employee for purposes of the Section 89 eligibility test.

It is not difficult to identify and classify as a potential leased employee an individual who is supplied to a business client by an organization which is *in the business* of supplying workers *to be supervised by that business client* in a manner similar to an employee. Secretaries, clerical personnel, bookkeepers, etc. are examples. However, major conceptual problems arise when one ventures away from this factual situation to identify non-supervised individuals as leased employees. The reason is that the "recipient" is contracting for a *service* to be performed, or goods to be supplied, by a third party and is not simply entering into an agreement to have workers supplied by such organization. In other words, the third party organization is in *the business* of, and holds itself out not as furnishing personnel, but as providing services or supplying goods. Workers are supplied by the third party organization to perform the service being contracted (or to supply the goods), and the job performance of the supplied worker is supervised by the outside organization and *not* by the recipient-client. Unless the underlying statutory definition of "leased employee" is changed to take account of this factual situation, the entire concept of "leased employees" and areas to which the concept is applied are in chaos.

Even a modest sized business can have dealings with dozens or hundreds of third party organizations which render services either on or off the recipient's business premises using many of their own employees to perform the services or to supply goods. It is likely that in many if not most cases the recipient has no idea who these workers are and would be utterly shocked if informed that such persons could be deemed to be such recipient's employees. This situation is magnified greatly in the case of a large corporate business dealing with thousands of third party organizations which provide an infinite variety of services through their own employees.

The foregoing may be referred to as the "bona fide service arrangement" problem which is facing nearly every business which deals with the complex tests under Section 89. Every such business, large or modest-sized, is faced with the same problem: is it necessary that information regarding names of workers, hours of work, benefit payments, salary levels, plan options, etc. be obtained from every person or organization which has provided workers performing services or supplied goods to the recipient? To do this would require enormous amounts of time and money. It is far from clear that such parties would be willing to provide the information that would be needed by the recipient-client either because of a perceived sensitivity to disclosing such information or due to the effort involved in supplying the data. Even the supplier of the service or goods to the recipient would *itself* become a "recipient" of services or goods which it received from others with whom it had business transactions providing services or goods. The amount of paperwork that would have to flow back and forth among U.S. businesses to satisfy a literal reading of the present definition of "leased employee," as well as the requirements that records be kept for identifying leased employees, is beyond comprehension.

In a bona fide service arrangement where the recipient contracts with a third party organization for the service or for goods, it is the third party organization which exercises supervision and control over the job performance of the workers supplied to carry out the service or to supply the goods. The statutory definition of "leased employee" does not properly take into account the distinction between an agreement simply to supply workers and an agreement to provide a bona fide service or to supply goods using the third party's own workers. This distinction, however, is monumental when viewing the extent to which a recipient is required to obtain information.

If the concept of "leased employee" is to remain in the Code, the definition must reckon with this distinction and should include some reasonable test which differentiates between workers whose job performance is and is not supervised or controlled by the recipient. Unless this is done, employers will be constantly faced with uncertainty even after expending huge amounts of time and money to gather informa-

tion. If a recipient does not supervise and control a worker's job performance under well-accepted common law principles, that should be a proper basis to exclude such worker as being a leased employee of the recipient. On the other hand, to prevent abusive situations, *former* employees who are performing services to the recipient on substantially the same basis as previously performed, but who are nominally employed by third parties, may have to be treated as leased employees

The third element of the present "leased employee" definition providing that the service performed is one "historically performed" in the "business field" of the recipient is, as a practical matter, unworkable as a limitation. It is not the *recipient's* own experience that is determinative; rather, it is the "business field" of the recipient. The term "business field" is undefined and could be one field for one particular job and a different field for another job. For example, security guards and food handlers are used by nearly all sizable businesses in *all* business fields, not in just a single field. If the guard or food handler provides services to a retail women's store, is the entire field of the U.S. to be viewed, or the "retail industry" in general, or only the "business field" comprising other retail women's stores?

There is no known, reliable information service available in the United States to determine whether a particular job is performed within the "business field" by employees of other businesses comprising the business field, even assuming one could identify the correct "business field." In essence, the definition of "leased employee" establishes a requirement which cannot be met and thus reflects highly questionable tax policy. As a result, the definition of "leased employee" really has only two elements: did the worker perform services under any form of agreement and did the worker perform services to the recipient for at least one year (or only months when health care plans are being tested)? When this shortcut but essentially practical version of the definition is coupled with the "bona fide service arrangement" problem discussed earlier, it can be seen that an employer is indeed faced with a nearly impossible task due to a definition which is far too broad in scope.

RECOMMENDATION

The definition contained in section 414(n) should be narrowed to include those workers who have some real indicia of an "employee." The definition should differentiate between workers who are subject to supervision of job performance by the recipient and those workers who are not.

The "historically performed" portion of the definition of "leased employee" should be repealed. Such portion establishes a "business field" test for the employer which is unnecessary and too vague for practical application. Even if one could identify the requisite "business field," there is no known, reliable information readily available for an employer to determine whether a particular job is performed by employees of other business firms comprising the "business field."

STATEMENT OF THE U.S. SMALL BUSINESS ADMINISTRATION

(SUBMITTED BY FRANK S. SWAIN, CHIEF COUNSEL FOR ADVOCACY)

Mr. Chairman and Members of the Committee on Ways and Means: As Chief Counsel for Advocacy of the U.S. Small Business Administration, I am pleased to appear before you to discuss small business problems with Internal Revenue Code Section 89 and to offer suggestions for improving H.R. 1864, a recent proposal to simplify the law. Although Section 89 applies to many facets of the fringe benefit package, its impact on health benefits is our primary concern, and it is appropriate that the Committee has chosen to expeditiously review this law. Your Committee is to be commended for holding these hearings and for keeping the record open to suggestions for meaningful reform.

As you know, Section 89 was never intended to stimulate additional benefit coverage, either health care or life insurance; rather, Section 89 was meant to promote more equitable distribution of benefits, where the firm and its employees receive tax subsidies for the provision of those benefits. It is premised on the belief that the subsidy alone—the exclusion of such benefits from employees' gross income—will induce the highly compensated employees to compel the employer to extend benefits to all employees of the firm. Section 89 sets the parameters for treatment of employer sponsored fringe benefit plans to ensure that the substantial tax expenditure for excluding the value of health coverage from income, $36 billion, is efficiently used. It is this subsidy approach upon which the voluntary, employer-sponsored health benefit system is based.

Although few disagree with the concept behind these tax policy goals, businesses, large and small, have appropriately criticized the means to accomplish these goals, specifically the method adopted for testing equitable distribution. Section 89 is overly complex, costly to comply with and to administer, and will impose unnecessary burdens on an already stressed employer-sponsored health benefits system. For many small employers, the paperwork and compliance costs of Section 89, together with uncertainty of compliance, will outweigh the tax benefits of the underlying subsidy, and discourage, rather than encourage the provision of health benefits. The goals of Section 89 can be served only through simpler, alternative approaches, which will ensure benefits are equitably distributed without overly burdensome administrative and compliance costs.

I believe that meaningful legislative reform of Section 89 must:

- Dispense with the complex testing arrangements and alternative minimum participation test in current law and adopt a design-based approach.
- Eliminate the requirement that employees actually participate in the health plan in favor of a requirement that the firm make the plan available to a certain proportion of its employees.
- Reduce data requirements, paperwork and compliance burdens.
- Adopt in the statute costing method for determining value.
- Raise the threshold for part-time workers.
- Eliminate any set dollar amount thresholds in favor of simpler percentage tests which directly reflect changes in health care costs.

H.R. 1864 advances reform of present nondiscrimination rules. Two alternatives that might be considered, however: (1) replacing the dollar amount for maximum employee contributions with a percentage of minimum employer contributions designed in a way to assure affordability; and, (2) developing transitional rules to phase-in the coverage of part-time workers and the minimum employer percentage contribution.

I. EMPLOYER-PROVIDED HEALTH BENEFITS IN SMALL FIRMS

I would like to direct my remarks here today to the effect of current law and the recently introduced legislative proposal on small business health benefits. Health care coverage and maintenance of the voluntary, employer provided health benefit system is of great concern to this Administration. Before discussing the relative merits of H.R. 1864, however, I would like to dispel a common misconception that has fueled much of the debate on Section 89: that small employers tend to discriminate in the provision of health benefits.

While it is true that about three-quarters of the working uninsured and their dependents are found in small firms, our studies show that small firms with health benefits more frequently offer coverage to all their employees than do large firms. About 44 percent of small firms with fewer than 100 employees versus less than 25 percent of large firms (more than 100 employees) indicate that all employees are eligible for health insurance coverage[1] (chart 1). Small firms that do not extend health care to their employees, on the other hand, fail to do so because they can not afford the high insurance cost. variable or lower profitability make it difficult to incur these costs.[2]

Part-time and seasonal workers in small firms are also more likely to have the opportunity for coverage. In large firms, 76 percent of part-time workers [3] and 59 percent of seasonal and temporary workers [4] are excluded from health coverage compared with 68 percent and 49 percent, respectively, in small firms. Furthermore, part-time and seasonal workers are more likely to be found in small firms. Part-time employees working less than 35 hours comprise almost 30 percent of the small firm workforce compared with about 16 percent in large firms.[5] Largely as a result of the higher proportion of part-time workers, labor turnover is also much higher in

---

[1] ICF Incorporated, *Health Care Coverage and Costs in Small and Large Businesses* (Washington, D.C.: prepared for the U.S. Small Business Administration, Office of Advocacy, Under Award No. SBA-9267-AER-85, April 15, 1987), p. III-18.

[2] ICF Incorporated, *op. cit.*, pp. III-11, III-15 to III-16.

[3] *Ibid.*, p. III-16.

[4] *Ibid.*, p. III-16.

[5] *The State of Small Business: A Report of the President (Washington, D.C.: U.S. Government Printing Office, 1986), p. 245.*

small firms. About 27 percent of workers in small firms move emery year compared with 15 percent in large firms.[6]

The Committee should also recognize that when small firms extend benefits to their employees, they also tend to pay a larger share of the premiums. About 52 percent of small firm workers in firms with fewer than 100 employees versus less than 43 percent of large firm (more than 100 employees) workers indicate they pay nothing for health insurance (Chart 2).

Premiums are also costlier for employers in small firms. Small firm employers pay average monthly premiums about 10 percent higher for single coverage than large firm employers—$87 compared with $80. For family coverage the premiums are over 20 percent higher—$183 compared with $152 (Chart 3).

II. PRESENT LAW ADVERSELY AFFECTS SMALL BUSINESS

Health benefits are very important for small employers. The costs of benefit packages aria increasing at a time when the growth rate of the workforce is decreasing. These benefit packages are particularly important for attracting and retaining workers. After paid vacations, health insurance is the most common fringe benefit offered by firms. Of the nonagricultural, private wage and salary workers, 50 million employees, or 62.5 percent, have direct employer-provided health plans. Firms of less than 100 employees cover approximately 15 million workers in this category.

Tax policy changes in 1986 attempted to more closely connect the receipt of tax subsidies for health benefits for highly compensated employees with that of the larger workforce. However, the approach used in the Tax Reform Act premised fairness in actual receipt of benefits by non-highly compensated employees at the distribution point, rather than simply assuring nondiscriminatory availability. By relying on receipt for the nondiscrimination test, employee choice became a controlling factor for small employers, and made it possible for small groups to be in compliance one day, and out of compliance the next, without changing their plans. For small business, where 14 percent of employees who are offered health benefits decline coverage, workforce changes and employee choices can greatly affect a firm's ability to meet the nondiscrimination requirements.

Small employers are disadvantaged by the imposition of complex and costly compliance measures added to spiraling health care costs. Small employers who are faced with an exceedingly difficult legal maze, and a volatile health insurance market will limit their exposure to such a market by restricting or withdrawing employer sponsored coverage.

Furthermore, present law significantly disrupts small employer relationships with traditional providers of insurance information, i.e. insurance agents. Small employers rely upon these sources of information since they do not usually utilize employee benefit experts. Though such cost is deductible, so is the cost of employer-provided premiums. For employers for whom health insurance is marginally affordable, deductible premiums would be displaced by deductible plan services, thereby reducing actual health care spending for employees.

Our knowledge of health benefits among small firms leads us to conclude that affordability and access is key to the formation of small business health insurance plans, and that the necessity of delivering a broad group to the insurance carrier in order to receive or continue coverage controls how small business offers health benefits. The failure to offer any health plan whatsoever does not reflect discriminatory practices, but the failure of the underlying tax incentives to adequately stimulate the provision of health care. Section 89, in its present form, will impose additional costs at a time when small firms need it least.

III. CONSIDERATIONS FOR REFORM

The costs of compliance with current Section 89 are disproportionately imposed on small employers who already experience health costs of between 10 to 40 percent higher than large employers—discouraging, rather than encouraging the provision of health benefits. The steps toward simplification as drafted by this Committee are indeed valuable, especially the restructuring of nondiscrimination rules to address availability rather than actual receipt. Such restructuring dramatically decreases the data and recordkeeping requirements.

There are other problems endemic to the small business market that affect the higher premium rates. The fact that small business has higher per capita premium

---

[6] Berkeley Planning Associates, *Labor Turnover and Worker Mobility in Small and Large Firms* (Washington, D.C.: prepared for the U.S. Small Business Administration, Office of Advocacy, under Award No. SBA-2092-AER-87, December 1988), p. 3.6.

costs, higher employee turnover rates and greater use of part-time employees also increases administrative costs for small firms relative to large firms.

Small firms are much less likely to self-insure, which means that their policies must reflect both the limitations of size and the cost of state-mandated health benefits in their insurance policies. They are far less likely to be able to effectively control their costs as large firms by negotiation or by self-insuring.

The small employer market also seems to pay a substantially larger contribution for single employee coverage and much smaller for dependent coverage. Small employers are more likely to hire young single workers. In fact, two-thirds of all entry level workers are hired by small firms, and 66 percent of all workers ages 16 to 24 are employed by small firms. The Committee should recognize these essential components of health insurance premium costs as they consider H.R. 1864.

IV. H.R. 1864—FURTHER CHANGE NECESSARY FOR SMALL BUSINESS

H.R. 1864 would succeed in addressing several important policy concerns of small employers, while furthering the essential purposes of existing law. Most notably, the proposal would greatly reduce complexity, paperwork burdens and, ultimately, the costs of providing health care by small employers over current law. Yet, while the proposal represents a substantial improvement over current law, alternatives should be considered in at least two important areas: (1) achieving affordability through the establishment of minimum employer contributions determined on a percentage basis and (2) developing transitional rules to ensure a smooth phase-in of maximum contribution amounts and for the part-timers threshold.

Among the improvements to Section 89, the bill would permit a firm to more easily determine compliance with the distributional requirements by adopting a design-based approach. This will allow firms to initially determine what changes must be made in the plan in order to comply with Section 89, and will allow insurance companies to develop products that match these parameters. The design approach will also dispense with the need for audit and testing throughout the year by permitting easier analysis. An attendant advantage would be reduction in the data collection requirements by requiring the firm to track only the highly compensated employees. A design-based approach will also eliminate needless roadblocks to compliance by supplanting the requirement of actual participation by a percentage of employees in a firm with a test based upon availability.

Second, the proposal would equate costs with the value of a plan and continue efforts to develop a more complex system for valuation. While current law and the regulations anticipate a valuation table based on actuary studies, there is greater authority and logic in permitting employers to use a costing system to determine value, particularly for small employers. However, value should equate with cost where the same services are available, i.e. HMO's. The purpose for emphasizing value rather than costs in Section 89 is to alleviate problems that could develop from differences in cost, but not value, in different geographical areas Small employers, however, are generally located in one geographical area. Valuation will merely add another layer of needless complexity.

Third, the proposal would redefine "highly compensated employee" (HCE) by establishing a more easily understood salary baseline. The identification of HCEs is fundamental for purposes of determining if a firm "discriminates" in their favor. The current law's three-tiered approach for purposes of determining who is a HCE added greatly to the expense of running the test and to the uncertainty of a firms's compliance with Section 89 when the status of HCE's changed.

Finally, the proposal makes needed advances to the issue of affordability by raising the threshold level of part-time workers that must be offered benefits. The question concerning the appropriate limits of coverage to part-time employees is often couched as a philosophical debate on the extent of employer responsibility. Far more than just a philosophical question, the extension of benefits to part-time workers raises real problems of adverse selection and affordability of the plan to all workers. Insurance companies know that part-time workers are generally greater health risks, and either do not permit them to participate in group health plans or raise rates accordingly.

The proposal, however, raises significant issues. To stimulate affordability, the proposal sets a maximum employee contribution by a set dollar amount. This contribution would be indexed to the social security wage base. The theory is that as medical expenses escalate, the maximum required employee contribution will increase. However, increases in health care costs bear no connection to this index, and could cause considerable noncompliance as health inflation rates escalates beyond the index.

In addition, the test does not take into consideration changes in health care costs for geographical locations. For small employers, who are all rated by such factors as geographical location, this will cause a great deal of disparity nationwide. The dollar value approach will allow the subsidy to be applied disproportionately across firm sizes. Furthermore, because small firms experience health care cost of between 10 to 40 percent higher than do larger employers a constant threshold for all firms will permit larger companies, with lower health care costs, to contribute a smaller share to their employees plan. Finally, indexing will add another layer of complexity for compliance and administration.

An alternative approach would be to use a percentage of employer contribution to the employees' health care premium costs. No indexing will then be needed, but the required employer contribution will increase with actual employer health care costs consistent with affordability.

Another essential improvement is to raise the part-time exception. We have heard from employers around the country that insurance companies do not insure employees who work fewer than 30 hours. New Hampshire has the only state law requiring insurers to make insurance available to employers for workers below 30 hours. Insurance companies assume that part-time workers who elect coverage are an adverse selection problem. We must note, however, that maintaining the limit at 25 hours presumes employment practices and insurance company practices will be altered to apply below the 30 hours range.

CONCLUSION

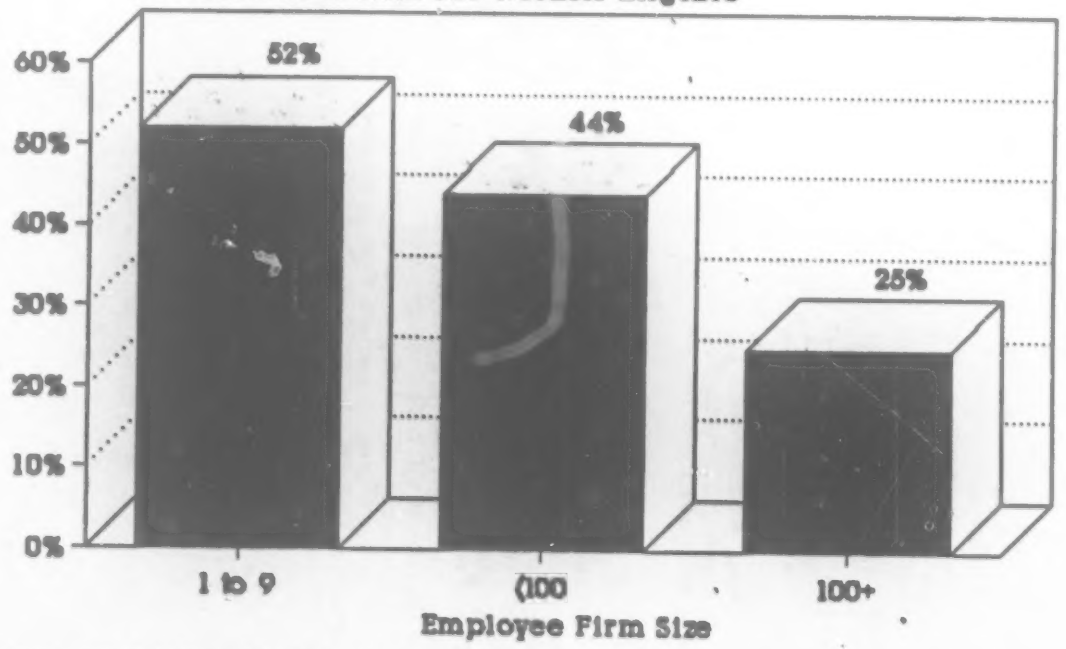
We are concerned that the dollar limitations for employee contributions might build in to the legislative proposal a level of inflexibility to the year-to-year changes in insurance premiums, as well as the geographical differences in health insurance premiums. A percentage of cost approach may also alleviate the need for indexing. Premium costs will track the rise in health care inflation, and take into consideration the fluctuation in the market due to geographical location which so greatly affect small employers.

As noted previously, we believe consideration should be given to a transition rule so that the market will not be unduly jolted by changes to the law.

Future innovative efforts in plan design will be affected by rising health care costs, the need to carefully manage these costs, and new government regulations such as Section 89.

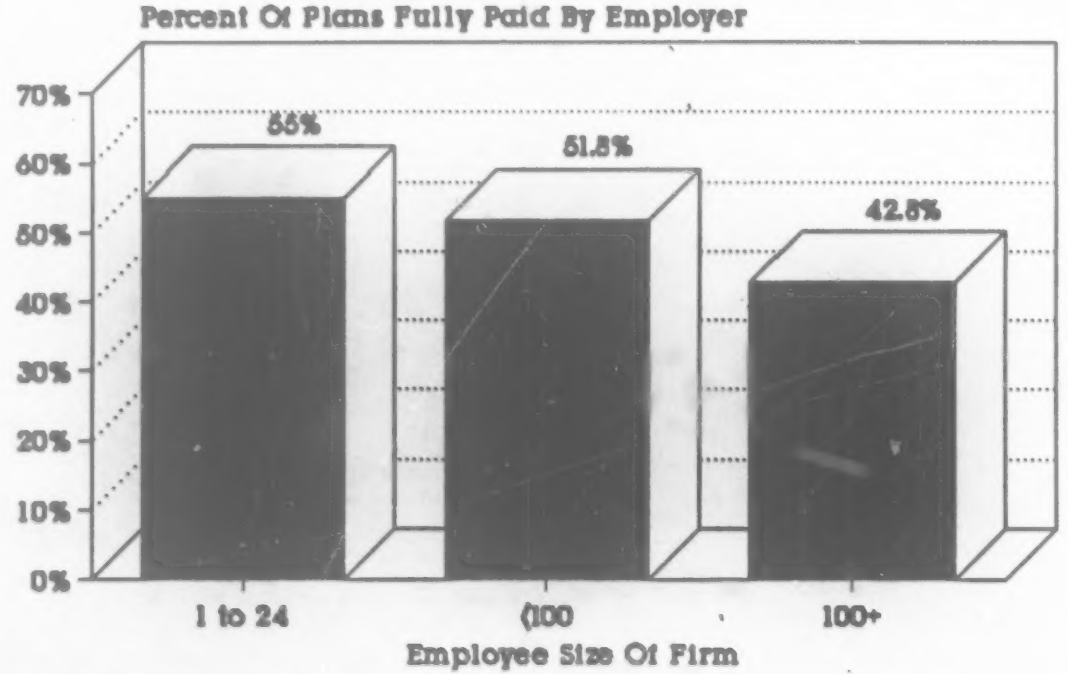
This concludes my prepared remarks. I would be pleased to respond to your questions.

Employee Eligibility For Health Insurance By Firm Size



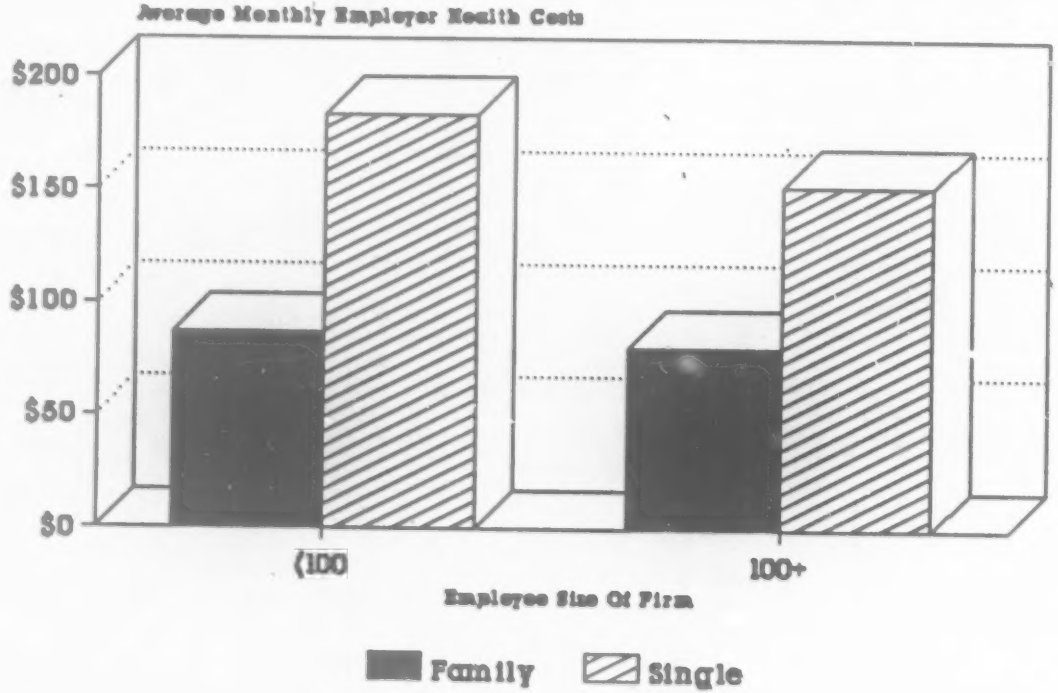
Source: Health Benefits Data Base, 1986

Proportion Of Employee Health Plans Fully Paid By Employer



Source: 1987 President's Report

Employer Costs Of Health Care



Source: EBA, Health Benefits Data Base, 1988 (inflated to 1990 using CPI medical care).

STATEMENT OF THE WASHINGTON BUSINESS GROUP ON HEALTH

The Washington Business Group on Health (WBGH) was established in 1974 to give major employers a credible voice in the formulation of federal and state health policy. When WBGH began, its membership consisted of five companies. Today, as an organization whose growth and diversity reflects corporate interest and sophistication in the health arena, WBGH works with both the home office and Washington based representatives of more than 150 of the Fortune 500 corporations. WBGH members direct health care purchasing for 40 million of their employees, retirees and dependents.

The WBGH has been concerned with the health policy implications of the Section 89 Non-discrimination Rules since early in 1986. Our staff has worked closely with a "Section 89 Committee" made up of the corporate staff who will be responsible for implementing Section 89.

As an organization whose members are deeply concerned with the overall problem of access to care for the uninsured, we are convinced these rules will inhibit increased health benefit coverage for the employed. It would be foolhardy for any business currently not offering coverage, to begin to do so in light of these rules. Furthermore, there is preliminary evidence that some employers may drop coverage as a result of these rules.

Following is a summary of our concerns regarding the Section 89 rules and their effect on revenue, small and large business, the changing workforce and dependent coverage:

1. *Revenue*—While it may be true that the S. 89 rules will raise small amounts of revenue by taxing certain benefits of the highly paid, we believe that in the long run more revenue will be lost than raised. Large companies that offer health insurance estimate implementation costs at millions of dollars. These dollars are tax-deductible and will increase the revenue loss associated with the provision of health benefits, yet there will be no additional health care benefits provided. S. 89 is merely a highly inefficient form of taxation of benefits.

Furthermore, as tax policy, S. 89 is contrary to the desired social policy outcome of expanded coverage. The S. 89 rules send a confusing message to employers: the Congress and the Administration want you to offer health insurance but you must also comply with an enormously complex set of regulations. Yet, if you don't offer coverage you are free from any compliance burden. This is not good tax policy or good social policy.

2. *Small Business*—A large percent of the uninsured are workers and their families (55% are workers and 32% are non-working members of workers' families). A majority of these workers are in the small business segment of the workforce (approximately half of all the uninsured are in small businesses with fewer than 25 employees). While there is debate on how to cover the uninsured, all agree that we must find more affordable ways for small business to offer health insurance. For the 60% of businesses with 25 or fewer employees that do offer coverage, the administrative burden of 5.89 is particularly onerous. These businesses usually do not have personnel devoted solely to health benefits with expertise to administer these tests. Since many small business owners are already overwhelmed with the complexity and cost of health insurance, these rules can only exacerbate the problems within the small business community. At a time when there are many employers that do not offer benefits at all, it is wasteful to expend these kinds of resources scrutinizing those who do offer benefits.

3. *Large Business*—Equally frustrated are large employers who feel that they are doing what the government wants them to; that is, they are offering health benefits to their employees. Now they must spend huge amounts of dollars and human resources to prove that these benefits are non-discriminatory. In a small informal survey (March 1989) of WBGH members on Section 89 compliance issues, WBGH determined that almost all of the respondents have begun procedures to comply with Section 89. The survey findings may or may not represent the business community in general given the relatively small number of corporate respondents (n=45). However, the information illustrates how companies are beginning to comply with Section 89. These respondents are already averaging costs of $70,000 just for the first two months of compliance, with the cost increasing upwards to $300,000. Under the current version of S. 79 the average compliance cost per year for these companies is $150,000, with a range from $15,000 to $450,000

In order to comply, large employers are spending most of their monies on hiring *outside* consultants, attorneys, and accountants. These outside firms must be hired in order to assist companies in wading through the maze of complicated Section 89 compliance tests. Once again these expenses are deducted by firms as the cost of

doing business and these dollars will certainly offset the small amounts of revenue which will be gained by taxing the benefits of the highly compensated. Further, there has never been any documentation of a vast problem that warranted regulation. Surely, if there are only anecdotal examples of abuse, these rules are an exaggerated solution.

4. *Addressing the Needs of a Changing Work Force*—Health costs have once again seized the headlines—we are experiencing unprecedented inflation rates in medical costs. Companies are searching for new and more aggressive methods to control spending and preserve quality.

At the same time the workforce is changing. Women and minorities will continue to account for an increasing percentage of the labor market.

Both these trends have led employers to offer more diversified health programs. Health plans that can be tailored to employees' needs can reduce the waste of health care dollars. For example, certain HMOs may offer rich pediatric benefits while indemnity plans offer physician choice to enrollees. These plans may attract a varied employee population (i.e. young families may opt for the HMO and older workers with ongoing health problems may choose the indemnity plan). These populations may vary in salary level (it would be natural to assume that older workers are on average more highly paid) because the plans genuinely attract those at different stages of life. However, these plans may end up being "valued" at very different levels causing difficulty when running the S. 89 tests. Thus, the S. 89 tests will encourage companies to eliminate choice and/or try to streamline benefits so that they are close enough in "value" to be aggregated. These S. 89 driven decisions may not allow employers to take into account variations that make sense for their employee population.

5. *Dependent Care*—Research has shown that the lack of dependent care is a large contributor to the problem of the uninsured. Children account for 33% (12.2 million) of the uninsured. Of these 12.2 million children there are approximately 2.3 million uninsured children whose parents are working and do have coverage. Often these children are not covered because the coverage is not extended to them or the contribution rates are too high. Furthermore, 8 million of these uninsured children are in families of uninsured workers. Under S. 89, companies that fully subsidize dependent coverage are provided administrative ease through new safe harbors. These safe harbors are a favorable aspect of the technical changes made under the Technical and Miscellaneous Revenue Act of 1988 (TAMRA). Companies that do *not* offer dependent coverage are obviously exempt from having to calculate dependent benefits under the testing requirements. Unfortunately, employers who can only partially subsidize dependent care coverage must test dependent coverage and are given no administrative relief under the new safe harbors. Clearly, this is the wrong message to be sending to an employer that wants to help defray the cost of dependent coverage but cannot afford the cost of full subsidization.

SUMMARY

Congress, faced with the crisis of the uninsured must carefully balance strategies that encourage the expansion of employer provided health benefits with the need to efficiently raise revenue. It is the belief of the WBGH that the S. 89 rules only exacerbate the already growing reluctance of employers, particularly small employers, to offer health benefits with virtually no economic gain. While it is fair for policy makers to require oversight of a tax favored program, it is short sighted to design a system which aggravates a broad public policy problem. It is truly disheartening to see the enormous time, energy and talent of employers and congressional and executive branch staff being spent on these rules rather than on designing positive strategies for expanding health coverage.

It is our belief that all parties would be better served by directly attacking the problem of the uninsured and making the difficult choices necessary to solve a problem of such magnitude and importance for this country.

STATE OF WISCONSIN, DEPARTMENT OF EMPLOYE TRUST FUNDS

Madison, Wisconsin, May 3, 1989.

VANDA MCMURTRY, ESQ.,
Chief Counsel, Senate Finance Committee,
U.S. Senate,
Washington, DC.

Dear Mr. McMurtry: On behalf of the Wisconsin Department of Employe Trust Funds, I write to submit our written statement in lieu of a personal appearance to testify about H.R. 1864, a bill to simplify the nondiscrimination rules applicable to employee benefit plans under Section 89 of the Internal Revenue Code.

Generally, the Department of Employe Trust Funds, which is the state's public employee benefit and public pension plan administrator for all state and almost all local government employees, strongly supports appropriate efforts to simplify Section 89. We recognize the purposes of this law. Unfortunately, we find that the present Section 89 and the Internal Revenue Service's recently proposed regulations as they apply to state government are limited in scope and raise many more complex issues than these regulations clarify. Several state employees have already concentrated several hundred hours to study and begin to understand this legislation at significant cost, and we have much more to do. When the deadlines arrive for the state to act under this law, we expect to make reasonable, but uncertain judgments with our fingers crossed about the state's approximately 53,000 present employees and 14,000 former employees who are covered under approximately 3400 health plans and a few hundred life insurance plans based on Section 89 definitions. We believe our health and life insurance system is inherently nondiscriminatory. Because of the character of our system and because of the possible significant tax consequences to our dedicated employees resulting from any judgment errors we may make under this very complex and unclear law, we request your help.

The state of Wisconsin is a large public employer. As a single employer the state consists of the legislative, the executive, and the judicial branches. These include the legislature itself; the executive, which includes approximately 62 state agencies, and the University of Wisconsin system, which consists of the University of Wisconsin-Madison, 12 other four year campuses, and 13 two year campuses; and the judiciary, which includes the supreme court, four courts of appeals, and 209 trial courts of record. These institutions rely on more than 53,000 persons who for the most part work in the cities of Madison and Milwaukee and the rest, in the 70 other counties around the state. These dedicated employees receive health insurance age under what we believe total approximately 3400 health plans, life insurance under several hundred life insurance plans, and for the University of Wisconsin system, several other benefit plans unique to the university's special circumstances.

The Wisconsin Legislature requires the state to provide substantially equivalent medical and hospital health benefits and life insurance benefits to all its eligible employees. The Legislature delegates to the state's Group Insurance Board the authority to implement these benefits. The Group Insurance Board includes the governor, the attorney general, the secretary of the Department of Employment Relations, and the commissioner of insurance, or their designees, and five other persons who participate in the system including a teacher, a nonteacher, a local government employee, a retiree, and another whom the governor appoints. The Board basically establishes comparable health benefits under the state's indemnity plan and its numerous HMOs at relatively similar costs and offers to all eligible employees any one of these plans under the same terms and conditions without any regard to the employee's salary level. The Group Insurance Board similarly implements the state's life insurance program. In each case, the Board offers these plans consistent with any applicable federal laws. The Department of Employe Trust Funds administers these benefit programs as a public trust. Secs. 40.01, 40.51, 40.52, and 40.70, Wis. Stats.

We support the efforts of Representatives Dan Rostenkowski and Thomas Foley and their colleagues to simplify Section 89 in their current proposal. While we believe their reasonable approach moves Section 89 in the right direction, we think they do not do enough to recognize the inherently nondiscriminatory character of some public employer benefit plans such as Wisconsin's plans. We do not propose that the Senate Finance Committee and the Congress exempt governmental plans from Section 89. Rather, we propose that this Committee and the Congress recognize in Section 89 that the public employer benefit plans that a legislature mandates are inherently nondiscriminatory because the legislative process with its competing interests virtually assures that all public employees, regardless of their position and compensation, receive comparable health and life insurance coverage.

We therefore respectfully urge the creation in Section 89 of a presumption for very large public employers to recognize the inherently nondiscriminatory character of such public benefit plans. We recommend the establishment of a conclusive presumption that the health and life insurance plans of any public employer employing more than 5,000 active employees are nondiscriminatory when a legislature either itself or through a government agency requires a public employer to make available to all active employees their choice of any one of two or more of all available plans

on the same terms and conditions without any regard to the employee's compensation. We think such presumption would recognize both the Congress's interests under Section 89 and, at the same time, the very large public employers' interests in their unique employer circumstances where a legislature requires a public employer to offer such comparable health and life insurance benefits to all employees on the same terms and conditions without regard to any employee's compensation. Moreover, we view such presumption as a rule that may encourage similar government employers to establish such inherently nondiscriminatory health and life insurance plans. The Department believes this is good public policy consistent with Section 89 that goes beyond the technical requirements of this law. We respectfully urge you to consider very seriously adopting such a proposal.

We are forwarding a copy of our letter to U.S. Senators Bob Kasten, (R., Wis.) and Herbert Kohl, (D., Wis.); Committee on Ways and Means Member Rep. Jim Moody, (D., Wis.) and the other members of the Wisconsin congressional delegation; Wisconsin Governor Tommy G. Thompson, and the state's legislative leaders.

If you have any questions, please contact us.

Thank you for your consideration.

Sincerely,

KEVIN B. CRONIN, *Chief Counsel.*

○

20-998 (296)